Capital asset also includes land situated within eight kilometres from the local limits of such municipality or cantonment as notified in the Official Gazette. [28] Capital gain arising from the transfer of such land is taxable only if the transfer has taken place after the date of the notification [29] and the land is included in the notification. [30] Land falling within a panchayat [31] or within a township constituted by a state legislation [32] but not falling within a municipality has been held not to be a capital asset. Agricultural land located in one State but within the municipality of another State was held to be capital asset. [33]

By virtue of substitution of cl (b) by the Finance Act, 2013 with effect from April 1, 2014, such distance is to be measured aerially, two, six or eight kilometers from the local limits of the municipality or cantonment board as the case may be.

6 . ***Explanation*** . --The Explanation was inserted by Finance Act, 2012 with retrospective effect from 1-4-1962. This is one of the several amendments that were made retrospectively to nullify the decision of the Supreme Court in the *Vodafone* case. [34] The Supreme Court had held that rights of management or control do not constitute separate assets but are incidental to the holding of shares. The control of a company depends on the voting power of the shareholders. The controlling interest is an incidence of ownership and something that flows out of the holding of shares. Controlling interest is not an identifiable or distinct capital asset independent of holding of shares. [35] Ironically, the Department had itself successfully argued that a controlling interest is not an asset before the Madhya Pradesh High Court.

With this amendment, the transfer of shares which takes place outside India will result in transferring the rights of management or control or any other right whatsoever in India. Therefore, if the shares of a foreign holding company are transferred, those shares, if significant in number, may result in transferring management or control. These rights will be treated as capital assets and be liable to capital gain tax. But how are these rights are to be valued? If shares are transferred overseas for a USD 1 billion, what is the percentage is attributable to management or controlling rights? Suppose 48 per cent. shares are transferred which does not give any management or controlling rights, then what is the liability to tax? Will the Department still bring the transaction to tax on the ground that the voting rights have been transferred and seek to place a value on them? It can be argued that in the absence of a mechanism to compute the value, no capital gains tax can be levied following the principles laid down in *Srinivasa Setty.* [36]

This amendment has been wrongly characterized as clarificatory. It was never in doubt that management/controlling rights have no independent existence but are only incidental to the ownership of shares. But Parliament has freely used the words "for removal of doubts" and treated retrospective amendments as clarificatory. It is submitted that a mere use of these words will not make an amendment clarificatory. Similarly, the absence of these words will not mean that the amendment is *not* clarificatory.

In the context of this amendment, reference should be made to a letter dated May 29, 2012 bearing reference No.F.No.500/111/12009-FTD-1(Pt.), whereby the Board has clarified that assessments which are completed under **s 143(3)** before April 1, 2012 will not be reopened under **s 147** on the basis of this amendment.

But an assessment which stands validated because of the clarificatory amendment will be enforced. In other words, if an assessment order has treated a management right as an independent asset and proceedings are still pending, the retrospective amendment would be applied.

7. Burden of Proof. --The burden is on the assessee to prove that the land was agricultural land on the date of the transfer. [37] In this connection, insofar as sub-clause (iii) is concerned, it has been held that the distance referred to in the clause has to be measured not as a straight distance, but as distance in terms of the approach by road. [38] Further, it has been held that a certificate of a district authority or Tehsildar in this respect would be given weight in determining whether the distance requirements are satisfied. [39] These decisions are no longer good law as the newly amended provision provides for measurement aerially.

8. Reference to Court. --The question whether the land is agricultural land is essentially a question of fact. [40]

In the context of **s 2 (14)** , the undernoted case held that a referable question of law did not arise [41] under **s 256** .

[42] ((15) "charitable purpose" includes relief of the poor, education, medical relief, [43] (preservation of environment (including watersheds, forests and wildlife) and preservation of monuments or places or objects of artistic or historic interest,) and the advancement of any other object of general public utility:

Provided that the advancement of any other object of general public utility shall not be a charitable purpose, if it involves the carrying on of any activity in the nature of trade, commerce or business, or any activity of rendering any service in relation to any trade, commerce or business, for a cess or fee or any other consideration, irrespective of the nature of use or application, or retention, of the income from such activity:)

[44] (*Provided further* that the first proviso shall not apply if the aggregate value of the receipts from the activities referred to therein is [45] (twenty-five lakh rupees) or less in the previous year;)

Clause (15) (of the 1922 Act): Charitable Purpose. --This sub-section defines "charitable purpose" and is closely connected with ss 11-13A and 80G of the Act. The recent spate of amendments to this section have gravely jeopardised the work of many charitable organisations, with the result that what is given with one hand is taken away by the other.

The definition in the 1922 Act was nearly identical to the original 1961 Act and mentioned four categories of activities:--(i) relief of the poor, (ii) education, (iii) medical relief and (iv) advancement of any other object of general public utility. The only addition in the 1961 Act were the words "not involving carrying on any activity of profit", which implied that an organisation carrying on a profitable activity would not be "charitable". The **Finance Act** , 1983 amended **s 11** and granted an exemption to profits and gains of businesses of charitable organisations as long as the conditions in **s 11(4)** were fulfilled. Consequentially, the words "not involving the carrying on any activity of profit" were removed.

The present definition in **s 2(15)** was substituted by Finance Act, 2008 and the first proviso was added to state that the advancement of any other object of general public utility will cease to be a "charitable purpose" if it involves any "trade, commerce or business". The proviso is very widely worded, and implies that even the smallest commercial activity will render the entire organisation not charitable.

From April 1, 2009, preservation of environment, and preservation of monuments or places or objects of historical or artistic interest have also been added to the definition, implying that these are now taken out of the category of "general public utility", There are now four specific categories and the fifth category refers to "advancement of any other object of public utility".

The Finance Minister, in his budget speech of 2008, mentioned that the CBDT would issue guidelines to determine whether an entity is carrying on any activity in the nature of trade, commerce of business, and had stated that Chambers of Commerce and similar organisations would not be affected by this amendment. However, no such guidelines were issued, and the Department issued notices to hundreds of organisations who were forced to file writs in various High Courts for appropriate orders.

A plain reading of the first proviso shows that it is linked only to the residuary category, i.e. general public utility, and not the first five categories. Therefore, the benefits of ss 11 to 13A and 80G cannot be denied to institutions and organisations falling within the categories of medical relief, relief of the poor, education, wildlife and heritage conservation merely because they carry on an activity generating profit. For instance, if an organisation seeks to advance AIDS awareness and sells contraceptives, the proviso will not apply to it since its object falls under "medical relief". Similarly, if a wildlife conservation organisation sells books or runs wildlife tours to spread awareness, it will not attract the proviso, since that would fall under "preservation of wildlife". The Department, however, has taken a contrary stand and if any organisation indulges in the slightest trace of any commercial activity, it will fall within the scope of this proviso. This is completely at odds with the words of the section and the explanatory circular issued by the CBDT.

The scope of these amendments was discussed in length by the Delhi High Court in a case whether activities carried on for imparting education amounted to business within the meaning of this clause. [46]

[47] ((15A) "Chief Commissioner" means a person appointed to be a Chief Commissioner of Income-tax under sub- section (1) of **section 117** ;)

[48] ([49] ((15B)) "child", in relation to an individual, includes a step-child and an adopted child of that individual;)

Clause (15B): Child. --In view of this definition a child includes a step-child, [50] notwithstanding the fact that the expression 'step-child' is alien to the personal law of the assessee. [51]

[52] ((16) "Commissioner" means a person appointed to be a Commissioner of

Income-tax [53] (or a Director of Income-tax) under sub- section (1) of **section 117** [54] (* * * *);)

[55] ((16A) "Commissioner (Appeals)" means a person appointed to be a Commissioner of Income-tax (Appeals) under sub- section (1) of section 117;)

[56] ((17) "company" means--

(*i*) any Indian company, or
(*ii*) any body corporate incorporated by or under the laws of a country outside India, or
(*iii*) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the **Indian Income-tax Act** , 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or
(*iv*) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board to be a company:

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971, or on or after that date) as may be specified in the declaration;)

Company

Clause (17) (of 1922 Act): Company. --The original definition, [57] which was replaced by the present one in 1971, was the same as in the 1922 Act, except that it included an 'Indian company' which is defined by cl (26) in wider terms than under the 1922 Act. Under the general law a company is a juristic person and is distinct from the shareholders; it is the company which owns the property and not the shareholders. [58] For the purposes of this Act, 'company' has a much wider connotation than the word bears under the Indian company law. Under this Act, 'company' includes even an unincorporated institution, association or body, whether Indian or non-Indian, which is declared by the Board to be a company. In such cases, what is not a legal entity would yet be assessable as a company. Further, from the assessment year 1971-72 onwards the present definition brings within its fold every company incorporated in a foreign country, irrespective of any other consideration. For the prior assessment years a foreign company could be declared by the Board to be a company.

A company which is registered under the Indian company law would fall within cl (i) of the definition, and must be assessed as a company, even though its certificate of incorporation might have been improperly obtained, for the certificate is conclusive under **s 35** of the **Companies Act** , 1956. A company may be incorporated for a purpose other than that of carrying on business. [59] A company registered under **s 25** of the **Companies Act** , 1956 without a commercial or profit-making motive must nevertheless be assessed as a company

under this Act. [60]

A company in liquidation is a 'company' within the meaning of this sub-section, and the department is entitled (without leave of the winding up court) to call upon the liquidator of the company, as its principal officer, to make a return. [61] Likewise, penalty proceedings may be commenced against a company in liquidation for a default committed prior to liquidation. [62]

Limited companies who carry on business are separate taxable persons, and the profits and gains of their several businesses are separate profits and gains for the purposes of the Income-tax Acts. This is none the less true if one of the companies should be the parent company, and the other or others may be its subsidiaries of which the shares are held or owned by the parent company. [63]

Under the Government Trading Taxation Act , 1926, the government of any part of Her Majesty's Dominions, which carries on a trade or business, is deemed to be a company within the meaning of this Act for the purposes of levy and collection of tax on its business profits. [64]

(a) One-man Company.--A one-man company is a distinct assessable and legal entity as much as any other company. [65] 'A company may control another company or an individual, or an individual may control a company; but it does not necessarily follow, because the individual controls the company, or the company controls the company, or the company controls the individual, that the business carried on by the person or company controlled is necessarily a business carried on by the controller. [66] But in a fit case the principle of piercing the corporate veil may be invoked. [67] If the person who holds the beneficial interest in all or almost all the shares of the company causes such an arrangement to be entered into between himself and the company as constitutes the company as merely his agent for the purpose of carrying on his own business, the business will become, for all taxing purposes, his business and not that of the company, and he himself would be assessable on the profits of the business. [68] Whether the company is a sham or simulacrum or mere cloak for the principal whose business the company carries on as the agent or nominee, is a question of fact depending upon the special circumstances of each case. [69] The burden of proving that the company is a sham or simulacrum, or a mere agent or benamidar for another, lies on the Revenue. [70]

A 'legal proprietary entity' belonging to one man, which is not incorporated in any country outside India is not a 'company' under this clause. [71]

(b) Assessment on Companies.--As regards liability to tax under this Act, a company differs, broadly speaking, from other assessees in two respects:

(a) Under the Finance Acts the minimum taxable limit prescribed for other assessees does not apply in the case of a company: a company is liable to income-tax, however small its income may be.

(b) A company has to pay income-tax at a flat rate on the whole of its total income, whereas other assessees are taxed according to the graduated scale or slab system.

From the assessment year 2001-02, a company has to pay tax under **s 115JB** on eighteen and one half per cent. of its 'book profit', even if its total income is less or nil. [72] Under **s 104** (now deleted), in certain circumstances, an additional tax was levied on the undistributed profits of companies in which the public were not substantially interested. **Section 115-O** provides that the amounts declared, distributed or paid on or after 1st day of April, 2003 by a domestic company by way of dividends shall be charged to additional income-tax at the flat rate of fifteen per cent, in addition to the normal income-tax chargeable on the income of the company.

An assessment cannot be made on a company after it has ceased to exist and has been struck off the register of companies. [73] 'Amalgamation' and 'demerger', in relation to companies, have been defined in cl (1B) and cl (19AA) respectively.

(c) Company does not pay its Tax on Behalf of its Shareholders.--The company itself is chargeable to tax on its profits as a distinct taxable entity, and it pays the tax in discharge of its own liability and not on behalf of or as agent for its shareholders. [74] The result is that the shareholder is liable to tax in respect of the gross dividend without any credit for the tax assessed in the hands of the company.

The company's tax is not to be confused with the shareholder's tax which, barring specified cases, the company deducts at source under **s 194** when paying the dividend and for which the shareholder gets credit in his own assessment.

(d) Industrial Company or Trading Company--Finance Acts.--Several Finance Acts prescribed a concessional rate of tax for "an industrial company" and defined the activities that would be industrial. These cases are outside the scope of a commentary on the 1961 Act. In the following cases, it was held that the respective assessees came within the expression "industrial company" [75] while the following are the cases where the court held to the contrary. [76] Similarly, a higher tax was prescribed for trading companies. [77]

(e) Holding and Subsidiary Companies.--The nature of corporate structures, the relationship between a holding and subsidiary company, their *inter-se* obligations have been discussed in this landmark ruling. [78]

(f) Other Definitions.--This section also contains definitions for certain specified companies: cl (19) for 'company in which the public are substantially interested'; cl (19AAA) for 'demerged company'; cl (22A) for 'domestic company'; cl (23A) for 'foreign company'; cl (26) for 'Indian company'; cl (26A) for "infrastructure capital company"; cl (36A) for 'public sector company' and cl (41A) for 'resulting company'. Cl (1B), which defines "amalgamation", also explains what is an "amalgamated company".

Other definitions specifically in relation to companies include cl (20) for 'director', 'manager' and 'managing agent'; cl (32) for 'person who has substantial interest in the company' and cl (35) for 'principal officer'.

(18) "company in which the public are substantially interested"--A company is said to be a company in which the public are substantially interested--

(*a*) [79] (if it is a company owned by the Government or the Reserve Bank of India or in which not less than forty per cent. of the shares are held (whether singly or taken together) by the Government or the Reserve Bank of India or a corporation owned by that bank; or)

(*aa*) [80] (if it is a company which is registered under **section 25** [81] of the **Companies Act** , 1956 (1 of 1956); or

(*ab*) if it is a company having no share capital and if, having regard to its objects, the nature and composition of its membership and other relevant considerations, it is declared by order of the Board to be a company in which the public are substantially interested: *Provided* that such company shall be deemed to be a company in which the public are substantially interested only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971, or on or after that date) as may be specified in the declaration; or)

(*ac*) [82] (if it is a mutual benefit finance company, that is to say, a company which carries on, as its principal business, the business of acceptance of deposits from its members and which is declared by the Central Government under **section 620A** [83] of the **Companies Act** , 1956 (1 of 1956), to be a Nidhi or Mutual Benefit Society; or)

(*ad*) [84] (if it is a company, wherein shares (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) carrying not less than fifty per cent. of the voting power have been allotted unconditionally to, or acquired unconditionally by, and were throughout the relevant previous year beneficially held by, one or more co-operative societies;)

(*b*) [85] (if it is a company which is not a private company as defined in the **Companies Act** , 1956 (1 of 1956), and the conditions specified either in item (*A*) or in item (*B*) are fulfilled, namely:--

(*A*) shares in the company (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) were, as on the last day of the relevant previous year, listed in a recognised stock exchange in India in accordance with the **Securities Contracts (Regulation) Act** , 1956 (XLII of 1956), and any rules made thereunder;

(*B*) [86] (shares in the company (not being shares entitled to a fixed rate of dividend whether with or without a further right to participate in profits) carrying not less than fifty per cent. of the voting power have been allotted unconditionally to, or acquired unconditionally by, and were throughout the relevant previous year beneficially held by--

(*a*) the Government, or

(*b*) a corporation established by a Central, State or Provincial Act , or

(*c*) any company to which this clause applies or any subsidiary company of such company [87] (if the whole of the share capital of such subsidiary company has been held by the parent company or by its nominees throughout the previous year).

Explanation. --In its application to an Indian company whose business consists mainly in the construction of ships or in the

manufacture or processing of goods or in mining or in the generation or distribution of electricity or any other form of power, item (*B*) shall have effect as if for the words "not less than fifty per cent.", the words "not less than forty per cent." had been substituted;))

Clause (18) (Explanation l to Section 23A of 1922 Act): 'Company in which the Public are Substantially Interested'. --This definition is dealt with post under ss 104-108 (now deleted).

Sub-clause (c) in **s 2(18)(b)(B)** would apply to any company to which cl (b) applies, which will also include any company which may be subsidiary of a holding company. In other words, requirements of sub-clause (c) could be fulfilled either by any company to which this clause applies, or any subsidiary company of such company, where such subsidiary company fulfills the condition laid down in clause (b) of **s 108** (now deleted). The question whether a company was one in which the public was substantially interested was relevant for the purpose of "deemed dividend" under **s 2(22)(e)** which would apply only to companies other than those in which the public was substantially interested. [88]

In the context of **s 2 (18)** , the undernoted case held that referable question of law did not arise [89] under **s 256** .

(19) "co-operative society" means a co-operative society registered under the **Co-operative Societies Act** , 1912 (II of 1912), or under any other law for the time being in force in any State for the registration of co-operative societies;

Clause (19) (of 1922 Act): Co-operative Society. -- T he definition of co-operative society in the 1922 Act was just the same. A regional rural bank to which the provisions of the **Regional Rural Banks Act** , 1976 apply is deemed to be a co-operative society for the purposes of this Act. [90]

The profits of any business of insurance carried on by a co-operative society are to be computed in accordance with the rules set out in the First Schedule [91] and certain categories of income of co-operative societies are exempt from tax under **s 80P** qv. Some other provisions dealing with co-operative societies are contained in ss 2(24)(vii), 2(47)(vi), 27(iii), 36(1)(i-a), 44, the proviso to **s 80-I(5)** , the provisos to **s 80J(2)** and **(3)** (now deleted), **s 80L(1)(ii)** , **(vi)** , **(viii)** and **(ix)** , Expln (b)(i) to **s 139(1)** (now deleted), proviso (ii-b) to **s 193** , ss 194C(1)(e), 269A(h)(ii), 269AB(1)(b), 269T and 269UA(f)(ii).

[92] ((19A) "Deputy Commissioner" means a person appointed to be a Deputy Commissioner of Income-tax [93] (* * *) under sub-section (1) of section 117;)

[94] ((19AA) "demerger", in relation to companies, means the transfer, pursuant to a scheme of arrangement under **sections 391** to **394** [95] of the **Companies Act** , 1956 (1 of 1956), by a demerged company of its one or more undertakings to any resulting company in such a manner that--

(*i*) all the property of the undertaking, being transferred by the demerged company, immediately before the demerger, becomes the property of the resulting company by virtue of the demerger;

(*ii*) all the liabilities relatable to the undertaking, being transferred by the demerged company, immediately before the demerger, become the liabilities of the resulting company by virtue of the demerger;

(*iii*) the property and the liabilities of the undertaking or undertakings being transferred by the demerged company are transferred at values appearing in its books of account immediately before the demerger;

(*iv*) the resulting company issues, in consideration of the demerger, its shares to the shareholders of the demerged company on a [96] (proportionate basis except where the resulting company itself is a shareholder of the demerged company);

(*v*) the shareholders holding not less than three-fourths in value of the shares in the demerged company (other than shares already held therein immediately before the demerger, or by a nominee for, the resulting company or, its subsidiary) become shareholders of the resulting company or companies by virtue of the demerger, otherwise than as a result of the acquisition of the property or assets of the demerged company or any undertaking thereof by the resulting company;

(*vi*) the transfer of the undertaking is on a going concern basis;

(*vii*) the demerger is in accordance with the conditions, if any, notified under sub-section (5) of **section 72A** by the Central Government in this behalf.

Explanation 1. --For the purposes of this clause, "undertaking" shall include any part of an undertaking, or a unit or division of an undertaking or a business activity taken as a whole, but does not include individual assets or liabilities or any combination thereof not constituting a business activity.

Explanation 2. --For the purposes of this clause, the liabilities referred to in sub-clause (*ii*), shall include--

(*a*) the liabilities which arise out of the activities or operations of the undertaking;

(*b*) the specific loans or borrowings (including debentures) raised, incurred and utilised solely for the activities or operations of the undertaking; and

(*c*) in cases, other than those referred to in clause (*a*) or clause (*b*),

so much of the amounts of general or multi-purpose borrowings, if any, of the demerged company as stand in the same proportion which the value of the assets transferred in a demerger bears to the total value of the assets of such demerged company immediately before the demerger.

Explanation 3. --For determining the value of the property referred to in sub-clause (*iii*), any change in the value of assets consequent to their revaluation shall be ignored.

Explanation 4. --For the purposes of this clause, the splitting up or the reconstruction of any authority or a body constituted or established under a Central, State or Provincial Act , or a local authority or a public sector company, into separate authorities or bodies or local authorities or companies, as the case may be, shall be deemed to be a demerger, if such split up or reconstruction fulfils [1] (such conditions as may be notified in the Official Gazette, by the Central Government);)

Clause (19AA): Demerger. --The **Finance Act** , 1999 made a number of amendments to this Act with a view to give tax concessions in relation to different forms of business reorganisation. These include new provisions for demerger, which is relatively a new phenomena in the Indian corporate sector. While there are no specific provisions governing demergers, under the Companies Act, some transactions of this nature do take place through schemes of compromise or arrangement under **sections 391** to **394** of the Companies Act and these are sanctioned by the High Courts. Under this new definition, a 'demerger' involves the transfer of one or more undertakings from a demerged company to a resulting company under a scheme of arrangement under ss 391 to 394 of the Companies Act. The term demerged company is defined in cl (19AAA) and means company whose undertaking is transferred. The term 'resulting company' is defined in cl (41A) and means company to which the undertaking is transferred.

In order to qualify as a demerger for availing several tax concessions which are now provided under the Act, the transfer has to fulfil the following conditions:

(i) All the property of and the liabilities relatable to the undertaking immediately before the demerger, being transferred by the demerged company, should become the property and liabilities of the resulting company.

(ii) The property and liabilities of the undertaking being transferred by the demerged company should be transferred at book value.

(iii) As a consideration for demerger, the resulting company should issue shares to the shareholders of the demerged company on a proportionate basis.

(iv) The shareholders holding not less than three-fourths in value of shares in the demerged company should become the shareholders of the resulting company.

(v) The transfer of the undertaking should be on a going concern basis.

(vi) The demerger will be subject to further conditions, if any, notified under sub-s (5) of **s 72A** .

Explanation 1 to the clause clarifies that the expression 'undertaking' shall include a part of an undertaking or a unit or division of an undertaking or a business activity taken as a whole but does not include individual assets or liabilities or any combination thereof which does not constitute a business activity. Explanation 2 to the clause enumerates the liabilities to be included. Such liabilities must arise out of the operations or activities of the undertaking and should comprise specific loans or borrowings raised and utilised for the activities of the undertaking. In case of general or multi-purpose borrowings, the includible liabilities should be determined in a proportionate manner in the ratio of the value of assets transferred in a demerger to the total value of the assets of the demerged company. Explanation 3 provides that the change in value of the assets upon their revaluation shall be ignored. Lastly, Explanation 4 provides that the splitting up or reconstruction of any authority or a body constituted under a Central, State or Provincial Act or a local authority or a public sector company into separate authorities or bodies or companies shall be deemed to be a demerger, if such split up or reconstruction fulfils conditions notified by the Central Government.

If the abovementioned conditions are fulfilled, the following tax concessions are available in relation to the demerger:

(i) The provisions of **s 32** relating to the aggregate depreciation allowable to and the apportionment of depreciation between the predecessor and successor entities are extended to a demerger involving the demerged and resulting companies (**s 32(1)(iv)** .)

(ii) Under **s 43** , the actual cost of the transferred assets to the resulting company in the case of a demerger shall be taken to be the same as it would have been if the demerged company had continued to hold the assets. In respect of assets transferred from the demerged company, depreciation to the resulting company is allowed on written down value of such assets in the hands of the demerged company (**s 43(6)** , Explns 2A, 2B.)

(iii) Carried forward loss and unabsorbed depreciation of the demerged company is allowed to be carried forward by the resulting company (**s 72A(4)**).

(iv) The benefits to which the demerged company was entitled under ss 10A, 10B, 33AC, 35A, 35AB, 35ABB, 35D, 35DDA, 35E, 41, 42,

80-IA and 80-IB will be available to the resulting company as if the demerger had not taken place or as if the conditions thereto continue to be fulfilled.

(v) Under **s 35DD** , expenses for demerger are to be allowed by way of amortisation of one-fifth thereof every year for a period of five years.

(vi) As a result of the demerger, capital gains tax is not leviable on the demerged company (**s 47(vib)**) or on the shareholders of the demerged company (**s 47(vid)**). Capital gains for the subsequent sale of shares in the demerged company or the resulting company is to be computed by prorating the cost of acquisition (ss 49(2C) and (2D)). In respect of shares in an Indian company which have become the property of the assessee in consideration of demerger, the period of holding of such shares in the demerged company shall be included in computing the total period of holding of the shares by the assessee (**s 2(42A)**).

(vii) Under **s 2(22)(v)** , any distribution of shares pursuant to the demerger by the resulting company to the shareholders of the demerged company is not to be treated as dividend.

This definition is, *inter alia* , relevant to ss 2(22)(v), 2(42A), 10A(7A), 10B(7A), 32(1)(ii)(4th proviso), 33AC(3)(c), 35A(7), 35AB(3), 35ABB(7), 35(D)(5A), 35DD, 35DDA(5), 35E(7A), 41(1), (Expln 2 (iv)), 42(2)(c) (proviso), 43(1) (Expln 7A), 43(6)(c) (Explns 2A and 2B), 47(vib), (vic) and (vid), 49(2C) and (2D), 72A, 79(a) (second proviso), 80 IA(12), 80 IB(12) and 115AC(5).

The provisions relating to taxation of the companies involved in the demerger and their shareholders are applicable only if the demerger fulfils the conditions of **s 2(19AA)** of the Act. Mere sanction of the High Court for demerger under the **Companies Act** , 1956 is, by itself, not sufficient. 'Undertaking' referred to in these provisions is not restricted to undertaking involved in some manufacturing activity but it also includes any non-manufacturing activity (including trading, agency, etc). The word 'property' appearing in this clause has a very wide meaning and in the context in which it is used it includes all assets, rights and interests which the demerged company owned or possessed immediately before the demerger, and which it could transfer to the resulting company. This would include intangible rights or assets not reflected in the accounts of the demerged company *e.g.* goodwill, self-developed patent, know-how, etc, or assets not appearing in the accounts owing to cash method of accounting. 'Shares' in this clause includes all classes of shares, whether voting or non-voting. Hence 'three-fourths in value of shares' means three-fourths in value of the aggregate share capital and not merely equity capital of the demerged company. The statutory changes do not stipulate that the shareholders of a particular class should be allotted shares of the same class, and thus, equity shareholders can be allotted preference

shares and *vice versa* .

[2] ((19AAA) "demerged company" means the company whose undertaking is transferred, pursuant to a demerger, to a resulting company;)

[3] ((19B) "Deputy Commissioner (Appeals)" means a person appointed to be a Deputy Commissioner of Income-tax (Appeals) [4] (or an Additional Commissioner of Income-tax (Appeals)) under sub- section (1) of **section 117** ;)

[5] ((19C) "Deputy Director" means a person appointed to be a Deputy Director of Income-tax [6] (* * *) under sub- section (1) of **section 117** ;)

(20) "director", "manager" and "managing agent", in relation to a company, have the meanings respectively assigned to them in the **Companies Act** , 1956 (1 of 1956); [7]

Clause (20) (of 1922 Act): Director, Manager and Managing Agent. -- 'Manager' 'Manager' and 'managing agent', but not 'director', were defined in the 1922 Act as bearing the same meanings as in the Companies Act. Clauses (13), (24) and (25) of **s 2** of the **Companies Act** , 1956 contain the following definitions respectively:

(13) 'director includes any person occupying the position of director, by whatever name called';

(24) 'manager means' an individual (not being the managing agent) who, subject to the superintendence, control and direction of the board of directors, has the management of the whole, or substantially the whole, of the affairs of a company, and includes a director or any other person occupying the position of a manager, by whatever name called, and whether under a contract of service or not;

(25) 'managing agent' means any individual, firm or body corporate entitled, subject to the provisions of this Act, to the management of the whole, or substantially the whole, of the affairs of a company by virtue of an agreement with the company, or by virtue of its memorandum or articles of association, and includes any individual, firm or body corporate occupying the position of a managing agent, by whatever name called.

[8] ((21) "Director-General or Director" means a person appointed to be a Director-General of Income-tax, or as the case may be, a Director of Income-tax, under sub- section (1) of **section 117** , and includes a person appointed under that sub-section to be [9] (an Additional Director of Income-tax or) a Deputy Director of Income-tax or an Assistant Director of Income-tax;)

Clause (21): Director General or Director. --An additional director is not covered by this definition clause. [10]

(22) "dividend" includes--

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

(*b*) any distribution to its shareholders by a company of debentures, debenture-stock, or deposit certificates in any form, whether with or without interest, and any distribution to its preference shareholders of shares by way of bonus, to the extent to which the company possesses accumulated profits, whether capitalised or not;

(*c*) any distribution made to the shareholders of a company on its liquidation, to the extent to which the distribution is attributable to the accumulated profits of the company immediately before its liquidation, whether capitalised or not;

(*d*) any distribution to its shareholders by a company on the reduction of its capital, to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before the 1st day of April, 1933, whether such accumulated profits have been capitalised or not;

(*e*) any payment by a company, not being a company in which the public are substantially interested, of any sum (whether as representing a part of the assets of the company or otherwise) [11] (made after the 31st day of May, 1987, by way of advance or loan to a shareholder, being a person who is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) holding not less than ten per cent. of the voting power, or to any concern in which such shareholder is a member or a partner and in which he has a substantial interest (hereafter in this clause referred to as the said concern)) or any payment by any such company on behalf, or for the individual benefit, of any such shareholder, to the extent to which the company in either case possesses accumulated profits; but "dividend" does not include--

(*i*) a distribution made in accordance with sub-clause (*c*) or sub-clause (*d*) in respect of any share issued for full cash consideration, where the holder of the share is not entitled in the event of liquidation to participate in the surplus assets;

(*ia*) [12] (a distribution made in accordance with sub-clause (*c*) or sub-clause (*d*) in so far as such distribution is attributable to the capitalised profits of the company representing bonus shares allotted to its equity shareholders after the 31st day of March, 1964, [13] (and before the 1st day of April, 1965);)

(*ii*) any advance or loan made to a shareholder [14] (or the said concern) by a company in the ordinary course of its business, where the lending of money is a substantial part of the business of the

company;

(*iii*) any dividend paid by a company which is set-off by the company against the whole, or any part of any sum previously paid by it and treated as a dividend within the meaning of sub-clause (*e*), to the extent to which it is so set-off.

(*iv*) [15] (any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of section 77A [16] of the **Companies Act** , 1956 (1 of 1956);

(*v*) any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company (whether or not there is a reduction of capital in the demerged company).)

Explanation 1. --The expression "accumulated profits", wherever it occurs in this clause, shall not include capital gains arising before the 1st day of April, 1946, or after the 31st day of March, 1948, and before the 1st day of April, 1956.

Explanation 2. --The expression "accumulated profits" in sub-clauses (*a*), (*b*), (*d*) and (*e*), shall include all profits of the company up to the date of distribution, or payment referred to in those sub-clauses, and in sub-clause (*c*) shall include all profits of the company up to the date of liquidation, [17] (but shall not, where the liquidation is consequent on the compulsory acquisition of its undertaking by the Government or a corporation owned or controlled by the Government under any law for the time being in force, include any profits of the company prior to three successive previous years immediately preceding the previous year in which such acquisition took place).

[18] (*Explanation 3* .--For the purposes of this clause,--

(*a*) "concern" means a Hindu undivided family, or a firm or an association of persons or a body of individuals or a company;

(*b*) a person shall be deemed to have a substantial interest in a concern, other than a company, if he is, at any time during the previous year, beneficially entitled to not less than twenty per cent. of the income of such concern;)

Dividend

1. Clause (22): (of 1922 Act): Changes in the Law. --The definition of dividend is the same as in the 1922 Act except for the following changes:

(i) Sub-clause (b) enacts that any distribution of shares by way of bonus to preference shareholders is taxable as dividend, whereas there was no such provision in the 1922 Act.

(ii) Sub-clause (e) originally made an advance or loan to, or a payment for the benefit of, a shareholder, taxable as dividend only if the shareholder was a person who had a substantial interest in the company within the meaning of cl (32), *i.e.* the shareholder beneficially owned at least 20 per cent. of the equity capital, whereas the corresponding sub-clause in the 1922 Act applied to all shareholders. The provision of sub-cl (e) is now extended to a shareholder who beneficially owns at least 10 per cent. of the equity capital, and to a concern in which such shareholder has a substantial interest as a member (Expln 3).

(iii) Explanation 2 did not occur in the 1922 Act.

2. Dividends. --This definition of dividend would not apply to a distribution or other payment made by a foreign company [19] unless that company falls within the definition of 'company' in s (17). [20] On the other hand, a dividend proper under the general law, received from a foreign corporation which is not a 'company' within the meaning of this Act, would nevertheless be liable to tax apart from this definition. [21] This clause would apply to a holding company and a subsidiary company. [22] The definition of 'dividend' is applicable to all provisions which contain the term 'dividend'' in the Act; [23] it is inclusive and not exhaustive; [24] and since it creates an artificial liability to tax, it should be strictly construed. [25] It merely extends the connotation of the word 'dividend' so as to comprise items of distribution or payment by a company which normally may not be regarded as 'dividend'. [26] The five instances of dividend enumerated in this clause are all of them cases of distribution or payment out of, or to the extent of, accumulated profits of the company. Any receipt by a shareholder which is 'dividend' under the general law would be taxable as such under this Act, even if it is not attributable to the company's 'accumulated profits' within the meaning of this clause or for any other reason falls outside this definition. (See further post under 'Dividend properly so called under general law, paid out of capital profits'.)

Under the **Companies Act** , 1956, a company cannot pay dividend otherwise than out of the profits of the year or any other undistributed profits. [27] However, 'there is nothing in law to prevent a company using an income receipt as cash in its hands to discharge a capital liability or to purchase a capital asset, and then, after the close of its financial year, paying a dividend out of other cash, or borrowing for the purpose, to the extent of the credit balance standing on profit and loss account. [28] In any event, dividend does not lose its taxable character as dividend merely because it is paid out of capital in violation of the law. [29] Similarly, non-observance by the company of the formalities required by the company law for declaration of dividend would not affect the shareholder's liability to taxation in respect of the dividend. [30] Under cl (24) 'income' is defined as including 'dividend'. What is

taxable as dividend need not necessarily be paid in money; it may be paid in money's worth by the delivery, say, of goods or securities or shares in another company; [31] and the amount of the dividend should be taken to be the market value of the money's worth on the date the dividend is declared. [32] An amount assessed as dividend under this clause cannot be taxed again as capital gains. [33]

A shareholder is liable to pay tax on his dividend income without any credit for the tax paid by the company on its own profits; and further, the company must deduct, under **s 194** (except as otherwise provided in that section), the shareholder's tax at source when paying the dividend, even if the payment is in the middle of the accounting year. [34] (See *ante* under cl (17), 'Company does not pay its tax on behalf of its shareholders'.)

In considering whether a distribution by a company is dividend or not, the personal motive or purpose of the individual shareholders is irrelevant; and if the distribution in law does not amount to a dividend, no tax can attach to it, whatever may have been the object underlying the distribution in that form. [35] 'In any case desires and intentions are things of which a company is incapable. These are the mental operations of its shareholders and officers. The only intention that the company has is such as is expressed in or necessarily follows from its proceedings. It is hardly a paradox to say that the form of a company's resolutions and instruments is their substance. [36]

A distribution of accumulated profits among shareholders, the amounts being not paid in cash but credited to the shareholders' individual loan accounts with the company, would nonetheless be taxable as dividend in the shareholders hands, [37] unless the dividend is set off by the company against a loan which itself had been assessed as dividend. [38] Similarly, a dividend would be taxable as such though it may be distributed on the understanding that it should be used by the shareholders in purchasing further shares in the company. [39]

3. 'Distribution'. --The 'distribution' referred to in the various sub-clauses of this clause may be or constructive. Distribution takes place when the amount due to each shareholder is credited to his account or is actually paid to him. However, the date of the appropriate resolution of the company, and not the date of distribution among the shareholders, fixes the date for ascertaining the quantum of accumulated profits. The Supreme Court laid this down in *Punjab Distilling Industries Ltd v CIT*, [40] which was a case of reduction of capital falling under sub-cl (d). There is a distinction between 'distribution' and 'payment' [41] but that does not take away the effect of the deeming provision of this definition clause. [42] Transfer of assets, under a scheme of amalgamation, by one company to another which is its shareholder does not involve 'distribution' within this clause. [43]

(a) Sub-clause (a): Distribution of Accumulated Profits Entailing Release of Company's Assets--Bonus Shares.--Under this sub-clause, 'dividend' includes any distribution by a company (i) which is of accumulated profits, whether capitalised or not, and (ii) which entails a release by the company to its shareholders of all or any part of its assets, the two conditions being cumulative. The expression 'accumulated profits' has been artificially defined by Explns 1 and 2 (see under the Explanations, post). A distribution of accumulated profits, whether capitalised or not, which does not entail a release by the company of its assets, would not be 'dividend'. A distribution of dividend by a company, prior to the **Companies Act** , 1956, out of the premium received on the issue of shares, is covered by this clause. [44]

Where a company capitalises its accumulated profits and issues bonus shares to its shareholders, the allotment of bonus shares does not entail a release of any of the company's assets--the company merely increases its capital by retaining the amounts available for distribution as dividends. [45] The bonus shares only give the shareholder an extra share in the capital of the company--they simply confer a title to a certain proportion of the surplus assets if and when a general distribution takes place as in winding up. The company does not part with any of its capital or assets: the profits remain with the company after being transmuted into capital. The House of Lords held in *IR v Blott,* [46] that bonus shares are not dividend. Under this Act, bonus shares are not dividend or income at all when they are issued to holders of ordinary or equity shares. [47] But if they are issued to preference shareholders, they would be assessable as dividend under sub-cl (b).

Similarly, where a company *bona fide* decides to capitalise its accumulated profits but offers its ordinary shareholders the option of accepting bonus shares or receiving in cash the nominal value of the bonus shares, the bonus shares accepted instead of cash would not be dividend, [48] but if a shareholder elects to receive cash wholly or partly in lieu of shares the cash would be dividend in his hands. [49] However, the position is entirely different where a company, instead of paying a dividend in cash or allotting its own bonus shares, distributes to its shareholders shares of another company. If a company applies its accumulated profits to buying the shares of another company and then distributes those shares among its own shareholders, there would be a distribution of accumulated profits entailing a release of the company's assets, and the shareholders would receive dividend in money's worth. [50] Thus where the shares of a subsidiary company are acquired by the parent company and the parent company declares bonuses on its own shares to be satisfied by the issue to its shareholders of the shares which it has acquired in the subsidiary company, the shares so distributed would constitute 'dividend' in the hands of the

shareholders of the parent company. [51]

(b) When Bonus Shares are Paid Off.--It has been noted above that bonus shares are not taxable as dividend when they are allotted to ordinary shareholders. But the further question that arises is whether, when bonus shares are paid off by the company, the payment constitutes a dividend within the meaning of this clause. Where accumulated profits are capitalised and redeemable preference shares are issued by way of bonus, the payment made by the company on redemption would constitute a distribution of capitalised profits entailing a release of some of the company's assets and would consequently be taxable as dividend under sub-cl (a) of this definition. [52] If accumulated profits are capitalised in the form of ordinary or preference bonus shares and such bonus shares are paid off by way of reduction of capital or on the liquidation of the company, tax may likewise be attracted under sub-cl (d) or (c) and the distribution to the holders of bonus shares may be treated as dividend. [53]

(c) Sub-clause (b): Debentures, Debenture Stock and Deposit Certificates--Bonus Shares to Preference Shareholders.--On general principles, where a company capitalised its accumulated profits and distributed bonus debentures among its shareholders, it was held that the debentures were not dividend or income at all in the hands of the shareholders. [54] In *IR v Fisher's Executors,* [55] Viscount Cave LC said:

> No doubt, the shareholders got debenture stock which, like the shares in *Blott'* s case, [56] was a valuable thing; but they had no power to call in the stock, which gave them no present right to receive any part of the company's assets either in money or in money's worth, but only entitled them to a sum to be carved out of those assets if and when the stock was paid off. It is true that debenture stock, unlike shares, creates a debt; but the debt in this case was not presently payable and may never become payable while the company is in existence. The whole transaction was 'bare machinery for capitalising profits and involved no release of assets either as income or as capital.

However, the Indian legislature has superseded this rule in this sub-clause, under which distribution of bonus debentures, debenture stock or deposit certificates in any form, by a company among its shareholders, would be distribution of dividend and consequently income in the hands of the shareholders, but only to the extent to which the company possesses accumulated profits, [57]

whether capitalised or not. The reference to deposit certificates was inserted to override the decision of the Madras High Court, [58] that where a company did not pay dividend in cash but issued to shareholders bearer deposit certificates payable on or before a certain date, the deposit certificate was like a post-dated cheque or a promissory note, and in such a case there was no release by the company of any of its assets and no distribution of dividend within the meaning of this clause as it then stood.

Unlike the 1922 Act, this Act taxes as dividend bonus shares issued to preference shareholders. The issue of bonus shares to ordinary shareholders is not taxable as dividend. (See *ante* 'Distribution of accumulated profits entailing release of company's assets--Bonus shares'.)

(d) Sub-clause (c), Sub-clause (ia) and Explanation 2: Distribution on Liquidation of Company. --In *IR v Burrell,* [59] the court of appeal held that accumulated and current profits distributed by the liquidator among the shareholders on the liquidation of a company are not dividend or income at all in the hands of the shareholders. The ground of the decision was that a liquidator cannot declare or distribute a dividend; on the liquidation of a company undistributed profits can no longer be distinguished from capital; the accumulated and current profits become merely surplus assets in the hands of the liquidator, and what he distributes among the shareholders is capital being their share in the property and assets of the company. [60] This principle was reaffirmed by the House of Lords and applied to the distribution on liquidation of a mutual insurance company in *Brogan v Stafford Coal & Iron Co Ltd.* [61] To supersede the rule in *Burrell'* s case, sub-cl (c) expressly provides that any distribution made to shareholders on the liquidation of a company to the extent of the company's accumulated profits falls within the definition of 'dividend' and is consequently taxable as income in the shareholders' hands. [62] But sub-cl (ia) provides that such distribution is not taxable as dividend if it is attributable to capitalised profits representing bonus shares allotted to equity shareholders after March 31, 1964 and before April 1, 1965. The reason is that bonus shares issued during that period were chargeable upon allotment to capital gains tax in the hands of the shareholders. (For the meaning of 'accumulated profits' see under Explns 1 and 2, post.)

The clause would apply even if the accumulated profits were capitalised. Thus, a distribution on liquidation out of capitalised profits, *e.g.* a distribution made in respect of bonus shares or a distribution out of profits capitalised by converting partly paid into fully paid shares, is dividend. [63] (See *ante* under 'When bonus shares are paid off.)

Explanation 2 makes it clear that distribution on liquidation out of the accumulated profits of any past year and even out of the

current profits of the year of liquidation but up to the date of liquidation, is taxable us dividend. [64] However, any distribution out of the profits of the company after the date of liquidation would not be covered by this clause. [65] In the case of liquidation consequent on the compulsory acquisition of the company's undertaking, any distribution out of accumulated profits of a period prior to three successive previous years immediately preceding the year of acquisition, is not taxable as dividend.

In the hands of the liquidator there is only one fund, but for the purpose of this clause each distribution made by him should be deemed to be received by the shareholder partly as capital and partly from accumulated profits. [66] That portion of the distribution is assessable as dividend which bears the same ratio to the amount distributed as the accumulated profits at the date of liquidation bear to the company's total net assets at the date of distribution.

An amount assessed as dividend under this sub-clause is to be reduced while computing capital gains under **s 46(2)** . [67]

(e) Sub-clause (d): Distribution on Reduction of Capital. --A company may, instead of increasing its capital by capitalising its accumulated profits, devote its accumulated profits to reducing its capital. In other words, the company may, out of its accumulated profits, pay off any share capital which is in excess of the wants of the company. [68] Or, a company may first capitalise its accumulated profits and increase its capital by issuing bonus shares and then reduce its capital by paying off such bonus shares. Under this sub-clause any such distribution by a company on the reduction of its capital is 'dividend' to the extent to which the company possesses accumulated profits which arose after the end of the previous year ending next before April 1, 1933, whether such accumulated profits have been capitalised or not. [69] The object clearly is to bring to charge a distribution of accumulated profits disguised as a reduction of capital. However, sub-cl (ia) provides that such distribution is not taxable as dividend if it is attributable to capitalised profits representing bonus shares allotted to equity shareholders after March 31, 1964 and before April 1, 1965. The reason is that bonus shares issued during that period were chargeable upon allotment to capital gains tax in the hands of the shareholders. For the meaning of 'accumulated profits' see under Explns 1 and 2, post.

(f) Sub-clause (e), Sub-clauses (ii) and (iii) and Explanation 3: Loans to Shareholders and other Monetary Benefits. --Sub-clause (e) has the effect of bringing to tax as dividend in the hands of the shareholders three types of payments made by a company:

(a) any payment of any sum (whether as representing a part of the

assets of the company or otherwise) by way of advance or loan to a shareholder; [70]

(b) any payment on behalf of a shareholder, and

(c) any payment for the individual benefit of a shareholder. [71]

The Supreme Court clarified that for the provisions on deemed dividend to be attracted, there must be payment in the form of a loan and, on the date of such payment, the company should have accumulated profits. But the Court's conclusion that there was "deemed dividend" is not clear. [72] It is submitted that although payment by way of advance or loan to a shareholder may amount to a "deemed dividend" under **s 2(22)(e)** , unless the other conditions mentioned therein are satisfied, a loan or advance made by one company to another in the ordinary course of business or inter-corporate deposits will not be treated as deemed dividend.

The conditions to be fulfilled in order to attract tax under this sub-clause are:

(a) the company should not be one in which the public are substantially interested within the meaning of cl (18);

(b)

(i) the advance or loan is made before June 1, 1987 to a shareholder who beneficially owns at least 20 per cent. of the equity capital (cl (32));

(ii) the advance or loan is made after May 31, 1987 to a shareholder who beneficially owns at least 10 per cent. of the equity capital, or to a HUF, firm, association of persons or body of individuals, in which such shareholder is beneficially entitled to at least 20 per cent. of the income, or to a company in which such shareholder beneficially owns at least 20 per cent. of the equity capital (Expln 3); and

(c) the company should possess [73] accumulated profits [74] at the time it makes the payment, [75] the payment being deemed to be dividend only to the extent of such profits. [76]

Mere book entries [77] or misappropriation of the company's funds [78] do not constitute payment by the company. A loan to a shareholder is deemed dividend, irrespective of the purpose of the loan. [79] The fact of repayment of loan even during the same accounting year is immaterial. [80]

Under this sub-clause the 'deemed' dividend is to the extent of the entire accumulated profits and not merely a portion of such profits proportionate to the assessee's shareholding in the capital of the company. [81] If the accumulated profits are capitalised, they cannot be taken into account for the purposes of this sub-clause. [82]

When a loan is deemed to be dividend, the same amount when repaid and relent cannot again attract the fiction and be once again deemed to be dividend. Therefore, in considering the taxability of subsequent transactions, the accumulated profits should be notionally reduced by the amount of all loans and other benefits which were once deemed to be dividend. [83]

Unlike cl (24)(iv) which applies to 'a person who has a substantial interest in the company', cl 22(e) applies to 'a shareholder, being a person who has a substantial interest in the company'. Thus in order to attract the application of this clause, the person should be a shareholder [84] and he should beneficially own at least twenty per cent. of the equity capital. [85] A shareholder means a person in whose name the shares stand in the share register of the company; [86] therefore, if a person is merely the beneficial owner of shares, without being the registered shareholder, this clause would not apply to him. Thus, where a Hindu undivided family is the beneficial owner of shares which are registered in the name of the *karta* or other coparcener, a loan given by the company to the joint family would not fall within this clause, [87] but it would if the family itself is a shareholder, [88] unless in the case of a loan made after May 31, 1987 the *karta* or other coparcencer is, at any time during the previous year, entitled to at least twenty per cent. of the income of the family (Expln 3). Similarly, before March 31, 1987, **s 2(22)(e)** would not apply to advances by a company to an assessee firm when the firm was not the shareholder but the partners of the firm were shareholders. [89]

An amount advanced as security to the firm in which two of the partners were shareholders of the company would not amount to a deemed dividend. The security was not a loan or advance as contemplated by **s 2(22)(e)** and, in addition, the firm receiving the advance was not a registered shareholder. [90] Similarly, if assessee is not a shareholder of the company from which he received a loan or an advance, the loan or advance cannot be treated as deemed dividend. [91] However, advance on commission paid to the managing director amounts to deemed dividend. [92]

Sub-clause (ii) constitutes the only exception to the above rule, and it applies only where two cumulative conditions are fulfilled--first, the loan should have been made by the company in the ordinary course of its business, and secondly, money lending should be a substantial part of the company's business. [93] The expression "substantial part" does not connote an idea of being the "major part" of the business or the part that constitutes majority of the whole of business. [94] Sub-clause (iii) gives relief by providing that any subsequent dividend paid by a company would not be taxable to the extent to which it is set off by the company against any loan or other monetary benefit which has been treated as a dividend within the meaning of sub-cl (e). If the dividend is not so

set off but is paid to the shareholder while the loan remains outstanding, the benefit of sub-cl (iii) cannot be obtained. [1] Regular business transactions between concerns cannot be treated as loans and advances and made taxable as "deemed dividend" under **s 2(22)(e)** . [2] Trade advances made in the ordinary course of business for commercial purposes will also be an exception. [3] Advances made to a sister concern that holds 50% of the equity of the assessee will not be treated as deemed dividend as the advance was to be adjusted against dues for job work and was a business transaction. [4]

In the context of **s 2 (22) (e)** , the undernoted case held that referable question of law did not arise [5] under **s 256** .

(g) Constitutional Validity. --The provision in the 1922 Act corresponding to sub-cl (d) was *intra vires* the central legislature. [6] Sub-clause (e) is not *ultra vires* the Parliament nor does it contravene **art 14 or 19(1)** of the **Constitution** . [7]

(h) Sub-clause (i): Shares Issued for Full Cash Consideration. --This sub-clause enacts that a distribution on liquidation of a company or on reduction of its capital is not dividend if it is made in respect of any share (i) which has been issued for full cash consideration, and (ii) which is not entitled in the event of liquidation to participate in the surplus assets. Generally speaking, preference shares are not entitled to participate in the surplus assets on liquidation.

(i) Sub-clauses (iv) and (v): Buy Back of Shares and Demerger. --Any payment made by a company on purchase of its own shares from a shareholder in accordance with the provisions of **s 77A** of the Companies Act is not dividend under this sub-clause. Similarly, any distribution of shares pursuant to a demerger by the resulting company to the shareholders of the demerged company is not dividend under this sub-clause.

(j) Explanation 1: 'Deemed' Dividend Paid Out of Capital Profits. --Explanation 1 to this clause enacts that the words 'accumulated profits', wherever they occur in this clause, do not include capital gains arising before April 1, 1946, or after March 31, 1948 and before April 1, 1956. For the purposes of the artificial categories of dividend which are created by this definition, 'accumulated profits' do not include any capital gains except those which are taxable as such. Thus 'accumulated profits' would not include capital gains which arose during a period when they were not taxable under the 1922 Act; [8] nor capital gains which are not chargeable even during the period the capital gains tax is in force, *e.g.* capital gains made on sale of some agricultural lands. [9] Consequently, any distribution made to the shareholders of a company on liquidation out of the non-taxable accumulated capital gains of the company would not be dividend.

(k) Dividend Properly so called under General Law, Paid Out of Capital Profits. --If a company pays a dividend, properly so called under the general law, out of its capital profits, *e.g.* profits realised upon sale or acquisition of some of its capital assets, the payment would nonetheless be dividend Income-taxable under **s 56** in the shareholder's hands, whether the payment is called dividend or bonus. [10] It would be so taxable even if the company's capital profits are not chargeable to capital gains tax and are not 'accumulated profits' within the meaning of Expln 1. A profit derived from the sale of a capital asset would not be taxable in the hands of the company, if the sale took place at a time when the capital gains tax was not in force. However, the capital profit which, while it remained in the hands of the company, was not income of the company, becomes income of the shareholders when it is paid to them. [11] This is now established by the decision of the House of Lords in *IR v Reid's Trustees,* [12] where Lord Normand summarised the position thus: A distribution of money to shareholders out of profits realised by the sale of the company's assets without any alteration of the share capital is normally a payment of the nature of income. It is fallacious to contend that when a company pays a dividend out of its non-taxable capital profits or sale proceeds of a capital asset, it is not dividend or income at all in the shareholder's hands but is a capital receipt. A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. Any other payment made by it by means of which it parts with moneys to its shareholders must and can only be made by way of dividing profits. Whether the payment is called 'dividend' or 'bonus', or any other name, it still must remain a payment on division of profits. [13]

(Cf *ante* under **s 2(1)** , 'Dividend paid by company out of agricultural income'.)

However, the Supreme Court has taken the contrary view. In *CIT v Nalin Behari Lall Singha,* [14] the Supreme Court held that a dividend proper which is paid by a company out of capital gains arising to it between April 1, 1948 and March 31, 1948 is not taxable as dividend since a distribution out of such gains is expressly exempted from tax for the purpose of **s 2(22)** . In *CIT v Saila Behari Lal Singha,* [15] the Supreme Court remanded the case to the High Court to consider whether such distribution could still be taxed as income other than dividend. In *CIT v Kamal Behari Lal Singha,* [16] the Supreme Court held that such distribution was not taxable even as income other than dividend, because it was made from a fund which was a capital receipt in the hands of the company and the shareholders merely took a share of the capital asset to which they were beneficially entitled. The above decisions, it is submitted with respect, are incorrect. First, as noted above, the definition in this clause is inclusive and not exhaustive and what

would be dividend proper under the general law (apart from this definition) is not touched in any manner by Explanation 1. An interpretation clause which extends the meaning of a word does not take away its ordinary meaning. [17] To accept that the definition of dividend in **s 2(22)** is inclusive and not exhaustive [18] and yet to say that dividend, properly so called under the general law, should not be regarded as dividend because of the definition in **s 2(22)** which artificially deems certain distributions or payments to be dividend, is to contradict oneself. It is submitted that Expln 1 can be invoked only in cases where a payment or distribution is not dividend under the general law but is sought to be taxed as 'deemed' dividend under **s 2(22)** . Secondly, a company and its shareholders are different legal entities and, for the purpose of considering the taxability of dividend, neither can the shareholders be regarded as beneficially entitled to the fund out of which the dividend is distributed nor can the capital character of the fund be taken into consideration. Thirdly, these decisions were rendered without considering, and run counter to, the prior rulings of the Supreme Court itself in *Bacha Guzdar v CIT,* [19] in which a dividend paid by a company out of its agricultural income was held not exempt from tax as being agricultural income in the hands of the shareholders, and *Kishinchand Chellaram v CIT,* [20] in which it was held that dividend proper does not lose its taxable character as dividend merely because it is paid out of capital in violation of the law.

(1) Explanation 2: 'Accumulated Profits'. --Explanation 2 defines 'accumulated profits' as including all profits of the company up to the date of distribution or payment, for the purposes of all sub-clauses except sub-cl (c). This provision, which was absent in the 1922 Act, [21] virtually renders the expression 'accumulated profits' wide enough to cover current profits, *i.e.* current profits of the year in which the distribution or payment is made, up to the date of such distribution or payment. [22] For the purposes of sub-cl (c) which deals with distribution on liquidation, 'accumulated profits' includes the profits of the year of liquidation up to the date of liquidation, but not the profits made between the date of liquidation and the date of distribution to the shareholders. [23] Explanation 2 further provides that where the liquidation is consequent on the compulsory acquisition of the company's undertaking by the government or a corporation owned or controlled by the government, accumulated profits do not include any profits of the company prior to three successive previous years immediately preceding the year of acquisition.

'Accumulated profits' means profits in the commercial sense. [24] The expression includes tax-free profits *e.g.* agricultural income, [25] general reserve, [26] development rebate reserve, [27] credit balance [28] and initial depreciation, [29] but not normal depreciation [30] nor provision for taxation and dividends. [31]

'Accumulated profits' does not necessarily mean reserves and other profits as disclosed by the company's balance sheet. [32] In every case, depreciation calculated at the income-tax rates should be deducted in computing 'accumulated profits', even if lower depreciation has been provided for in the accounts. [33] (See further post under deleted **s 109** , 'Reserves'.)

The Bombay High Court held that the expression 'accumulated profits' referred to the profits out of which the distribution was actually made. Any notional income of the company on which the company had been assessed but which never reached the company's hands and which consequently was not available for distribution among the shareholders-- *e.g.* notional dividend income under **s 23A** of the 1922 Act before the amendment of that section in 1955--could not be taken into account for the purposes of this clause. [34] This decision was rendered when the clause in the 1922 Act referred to 'distributionout of accumulated profits'. Now the clause refers to 'distributionattributable to the accumulated profits'. However, this decision would hold good even in cases arising under the present clause. All assessed profits are not necessarily accumulated profits. [35] For instance, 'accumulated profits' do not include amounts actually disbursed but disallowed in assessment, [36] nor do they include what is a capital receipt under the general law but is deemed, *e.g.* by **s 41(2)** omitted* which imposed a balancing charge, to be revenue profit for the purpose of assessment of the company. [37]

In determining the accumulated profits, the deemed dividend assessed under this clause in the past years should be deducted. [38]

(m) 'Excess Dividends'. --The provisions of the Finance Acts levying higher or additional tax on the company in cases where 'excess dividends' are distributed have been considered in the undermentioned cases. [39]

(n) Burden of Proof . --The initial burden to prove that a case is covered by this clause and therefore the amount is taxable as dividend is on the income-tax authorities [40] but the burden to prove that the case is covered by an exception is on the assessee.

(o) Exemptions and Deductions. --(See under **s 56(2)** .)

[41] ((22A) "domestic company" means an Indian company, or any other company which, in respect of its income liable to tax under this Act, has made the prescribed arrangements for the declaration and payment, within India, of the dividends (including dividends on preference shares) payable out of such income;)

[42] ((22AA) "document" includes an electronic record as defined in clause (*t*) of sub- section (1) of **section 2** [43] of the **Information Technology Act** , 2000 (21 of 2000);)

Clause (22AA) "Document". --Clause (22AA) has been added in the year 2001 to reflect the changes brought about by the **Information Technology Act** , 2000. The word "document" that earlier referred only to physical documents has now been expanded to include electronic documents as defined in **s 2(1)(t)** of the **Information Technology Act** , 2000.

[44] ((22AAA) "electoral trust" means a trust so approved by the Board in accordance with the scheme made in this regard by the Central Government;)

Clause (22AAA) -- Electoral Trust. --This clause has been inserted as part of a process to reform the system of funding of political parties and its scope explained in the undernoted circular. **Sections 80GGB** and **80GGC** were inserted by **Election and Other Related Laws (Amendment) Act** , 2003 which also amended ss 13A and 80A of the **Income-tax Act** , 1961. Needless to add that these amendments have not achieved any major reform. [45]

[46] ([47] ((22B)) "fair market value", in relation to a capital asset, means--

(*i*) the price that the capital asset would ordinarily fetch on sale in the open market on the relevant date; and

(*ii*) where the price referred to in sub-clause (*i*) is not ascertainable, such price as may be determined in accordance with the rules made under this Act;)

[48] ((23) (*i*) "firm" shall have the meaning assigned to it in the Indian **Partnership Act** , 1932 (9 of 1932), [49] and shall include a limited liability partnership as defined in the Limited Liability **Partnership Act** , 2008 (6 of 2009); [50]

(*ii*) "partner" shall have the meaning assigned to it in the Indian **Partnership Act** , 1932 (9 of 1932), and shall include,--

(*a*) any person who, being a minor, has been admitted to the benefits of partnership; and

(*b*) a partner of a limited liability partnership as defined in the Limited Liability **Partnership Act** , 2008 (6 of 2009);

(*iii*) "partnership" shall have the meaning assigned to it in the Indian **Partnership Act** , 1932 (9 of 1932), and shall include a limited liability partnership as defined in the Limited Liability **Partnership Act** , 2008 (6 of 2009);)

Partner and Partnership

Clause (23) (of 1922 Act): Firm, Partner, Partnership. --This definition clause is the same as in the 1922 Act.

In this Act, 'firm', 'partner' and 'partnership' have the same meanings respectively as in the Indian **Partnership Act** , 1932, with one difference, *viz* that for the purposes of this Act 'partner' includes a minor admitted to the benefits of partnership. [51] The Limited Liability **Partnership Act** , 2008 has introduced a new entity for the carrying out of business, i.e. a limited liability partnership, which is a hybrid entity having the features of both a company and a partnership. Under the Act , a limited liability partnership will be taxed in the same manner as a partnership firm. This is established by the change in the definition of "firm", "partner" and "partnership" in sub-clause (23), where suitable changes have been made to include a limited liability partnership and a partner in such a partnership.

The Finance (No. 2) Act, 2009 has substituted a new definition to include a limited liability partnership firm formed under the Limited Liability **Partnership Act** , 2008. This Act enables a partnership to have more than 20 partners and a limited liability partnership is a body corporate more akin to a company. (Till date, **s 11** of the **Companies Act** , 1956 limits the number of partners to 20).* A limited liability partnership is defined in **s 2(n)** to mean a partnership formed and registered under that Act.

(a) Validity of Partnership. -- ' Partnership' is the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. Persons who have entered into partnership with one another are called individually 'partners' and collectively 'a firm and the name under which the their business is carried on is called the 'firm name'. [52] The mere fact that two persons take a commission agency business jointly would not necessarily constitute a partnership between them. [53] A person, *e.g.* a deceased partner's widow, may be entitled to a share in the firm's profits, without being a partner. [54] It is open to the partners to agree not to take the whole of the firm's profits for their personal use and to reserve a part of the firm's profits for charity, though charity cannot be made a partner. [55] A representative, *benamidar* or trustee may be a partner without having any beneficial interest in the partnership. [56] A partnership between a company incorporated under the Company Act and its employees is a valid partnership. [57] A wakf cannot be a partner, but the *mutawalli* of a wakf can be. [58] A Hindu deity cannot enter into a partnership the provisions of which render its assets liable for the firm's losses. [59] A husband and wife governed by the Portuguese law can enter into a partnership in respect of the property of their communion. [60] A sub-partner cannot be regarded as a partner in the main firm because the sub-partnership and the main firm are two different entities for the purposes of the Act. [61]

In order to constitute a partnership there must be at least two majors. [62] If a partnership has been entered between two persons of whom one is a benamidar of the other, there is no relation of partnership between the two persons and one person cannot constitute a firm. [63] The total number of partners should not exceed twenty. [64] For computing this total number of twenty, minors admitted to the benefits of partnership are not to be taken into account. [65]

A guardian may contract and contribute capital on behalf of the minor, for the purpose of admitting the minor to the benefits of partnership, [66] even if he himself is one of the partners; [67] or the guardian may himself become a full-fledged partner. [68] A minor who is admitted to the benefits of partnership may be liable to share the firm's losses to the extent of his share in the partnership, *i.e.* his capital and his share in the profits and property of the firm; all that the law of partnership requires is that he should not be made personally liable for such losses. [69] The deed of partnership should be reasonably construed to determine whether the minor is merely admitted to the benefits of partnership and the partnership is therefore valid. [70] If a minor is merely admitted to the benefits of partnership, the question whether his guardian has or has not signed the deed or whether the minor has also signed the deed is irrelevant. [71] Where a partnership deed purports to be an agreement between a minor and majors, making the minor a partner, such a partnership is not valid and cannot be registered under this Act. [72] But after a minor attains majority, he is entitled to undertake the liability for losses that may be suffered for the entire accounting year in the course of which he attained majority. [73] Under **s 30** of the Indian **Partnership Act** , 1932, a minor alone can be admitted to the benefits of partnership and admitting a major, whether of unsound mind or whether deaf and dumb, to the benefits of partnership is impliedly prohibited. [74]

An association of persons would not constitute a partnership unless they carry on a business, [75] though a firm may not carry on business in a particular year. [76] But the business need not be one the income of which is taxable under **s 28** only. [77] The partners may do business in a line not mentioned in the deed of partnership [78] and may carry it on, not personally, but entirely through servants or agents. [79] It is essential that the principle of agency should regulate the relationship between the parties. [80] An agreement to share profits is equally essential to a valid partnership, [81] but the agreement may provide that some of the partners will not share in losses. [82] The profits need not be actually distributed every year. They may be allowed to accumulate in the business. [83] Partners are assessable on their firm's profits irrespective of whether the profits are distributed and paid over to them or not. [84] The amount which the partners are actually entitled to receive by way of share in profits may be made to depend upon the time which they devote to

the business of the firm, [85] or the share of a partner may be a fixed periodic amount. [86] A trade association or 'pool' formed by different traders with a view to promoting business and avoiding competition may constitute a firm [87] or may be assessable as an 'association of persons' [88] or may be a mutual association not liable to tax. [89] A French *societe en nom collectif* , which is a legal person distinct from the individuals composing it, is not a partnership. [90]

The question whether the relationship between two persons is that of partners, or of employer and employee or principal and agent, is a question to be determined upon a proper construction of the relevant documents and all the other circumstances of the case. [91] In the absence of other evidence, the mere fact that a person is remunerated by a share in the business profits would not be sufficient to establish a partnership. [92] It is not essential that in a partnership all the partners should be owners of the assets or the goodwill of the firm, or that the right of borrowing money on behalf of the partnership business should be exercisable by every partner. [93] A firm may be the owner of a property although on dissolution the property is to go to some partners only, or all partners except one are merely working partners and they have no right or claim to the property. [94] All the partners need not participate in carrying on of the business; likewise, every partner need not contribute capital. [95] Thus, it would be a valid partnership if a partner does not bring in any capital contribution to the partnership but contributes only his skill and labour. [96] The partnership would be valid though there may be various restrictions on some of the partners and one of the partners may be empowered to conduct the business at his sole discretion and to expel other partners from the firm or may be given other exclusive powers of dominating control. [1]

Partnership must be distinguished from co-ownership of property [2] and from the relationship of licensor and licensee [3] or vendor and purchaser. [4] On a true construction of a document, it may be held that the agreement between the parties constitutes a partnership, even if the document expressly declares that the arrangement set out therein shall not constitute partnership between the parties. [5] Conversely, an agreement which is merely to share expenses (and not profits) and which lacks the element of agency, would be held not to constitute a partnership, although the parties may describe themselves as partners, procure registration under the Indian **Partnership Act** and apply for registration under this Act. [6]

Where a firm's business was actually carried on by another firm, it was held not to be a genuine partnership and hence not entitled to registration. [7]

Partnership must be deemed to commence from the date when

in fact it has com menced, even though a partnership deed may be executed later. [8] Where partnership has in fact commenced from the date of execution of the partnership deed, it cannot be deemed to have commenced earlier even if the deed provides for retrospective operation; no deed can alter the past. [9] Likewise, if a partnership was in fact dissolved on a particular date, it cannot be held to have been dissolved earlier even though the deed of dissolution might refer to an earlier date as the date of dissolution for the purposes of adjusting the rights of the partners *inter se.* [10] A partnership may be assessed as such even after its dissolution, for instance, if it carries out after its dissolution contracts entered into before. [11]

(b) Illegal Partnerships. --Based on the different statutory provisions of different states and different conditions of respective licences, Whether a partnership is illegal as being in violation of the abkari, opium, tobacco or other licensing laws, would depend on the facts of each case. [12] In *Dayabhai & Co v CIT* , [13] Dixit CJ observed, 'The question of illegality of a partnership must be distinguished from illegality of any acts done in the course of its business by the firm or some or all of its members'. [14] As a result of the decisions of the Supreme Court in *Jer & Co v CIT,* [15] and *Bihari Lal Jaiswal v CIT* , [16] the law is well-settled and has been well summarised by a Full Bench of the Kerala High Court in *Narayanan & Co v CIT,* [17] thus:

> When the statutory provisions or the conditions of licence do not prohibit the formation of a partnership for exploiting the licence, such a partnership cannot be held to be illegal; but where there is a specific prohibition, any partnership entered into in contravention of these provision would be unlawful and void.

On application of these principles, a case similar to *Jer & Co* falling in the first category would be regarded as a genuine firm [18] but not a case similar to *Bihari Lal* falling in the second category. [19] However a sub-partnership formed merely to finance the business of a partner of the main firm doing abkari business is not in violation of the Abkari Act as the members of the sub-partnership do not become partners of the main firm, the two being different and distinct entities for the purpose of the Act and therefore not illegal. [20] Earlier, in some of the cases it was held that a partnership selling foreign liquor or country liquor [21] or other excisable goods, [22] or dealing in mica [23] or rice, [24] or doing mining [25] or fishing [26] or construction [27] business, may be legal, although the licence or lease or contract under the appropriate law

may not be held in the name of the firm and in some of the other earlier cases the courts held the partnership to be illegal and therefore disentitled to assessment as a firm, [28] but in view of the above discussion following *Bhari Lal* ruling, some of these cases may no longer be good law.

An illegal partnership may be assessed as an association of persons. [29] Needless to say, the legality of a firm would not be affected by its failure to comply with the rules of the trade association of which it is a member, [30] or by the failure of a partner to comply with the rules of the profession to which he belongs. [31]

(See further post under **s 2(31)** , 'Illegal association', and under **s 4** , 'Income tainted with illegality' and 'Sub-partnership'.)

(c) Genuine and Sham Partnerships. --The question whether a partnership is valid in law is distinct from the question whether a genuine partnership exists in fact. The distinction between the two does not seem to have been observed in some cases. The cases where the question really was of the genuineness of a partnership in fact as distinct from its validity in law have been dealt with post under ss 184-85, 'Genuine and sham partnerships'.

(d) Two Firms consisting of Same Partners. --Two firms consisting of exactly the same partners may nonetheless constitute separate and distinct partnerships and carry on different businesses; and the question whether two such firms are separate and distinct or whether they constitute only one firm, is a question of fact to be determined upon the circumstances of each case. [32]

(e) Joint Family, Company or Firm, or Same Individual in Different Capacities, as Partner. --It is not only individuals who can be partners in a firm. An incorporated company may form a partnership with an individual. [33] A joint Hindu family as such cannot be a partner in a firm; [34] but through its *karta* , it may enter into a valid partnership. [35] However, in such a case it is the karta alone who becomes the partner and not the individual members of the family, [36] and in determining whether the number of partners exceeds twenty in contravention of **s 11(2)** of the **Companies Act** , 1956, the *karta* alone should be counted as a partner and the members of the family represented by him should not be included. [37] SR Das J, delivering the judgment of the Supreme Court in *Kshetra Mohan-Sannyasi Charan v CEPT,* [38] said:

> When two kartas of two Hindu undivided families enter into a partnership agreement the partnership is popularly described as one between the two Hindu undivided families but in

> the eye of the law it is a partnership between the two kartas and the other members of the families do not *ipso facto* become partners. There is, however, nothing to prevent the individual members of one Hindu undivided family from entering into a partnership with the individual members of another Hindu undivided family and in such a case it is a partnership between the individual members and it is wholly inappropriate to describe such a partnership as one between two Hindu undivided families.

A partnership between two members of a Hindu undivided family and strangers would be valid, although the two members may represent, and receive their shares of profits on behalf of, one and the same family. [39] If after the formation of a partnership between the *karta* and a stranger, the joint family is disrupted, [40] or there is a partial partition by way of division of the interest in the partnerships, [41] the validity, constitution or existence of the partnership is not affected thereby. A widow is not competent to become the manager of a joint family and to enter into an agreement of partnership in her representative capacity as the manager; [42] but a female, as a member of a joint family, can become a partner in a firm as the representative of her family, [43] and in the absence of an adult male coparcener she can act as the guardian of her minor sons and represent the joint family for the purposes of assessment. [44]

A *karta* as representing his joint family may enter into a valid partnership with a separated member of the family. [45] As the Privy Council held in *Lachhmandas v CIT*, [46] and the Supreme Court in *Chandrakant Manilal Shah v CIT*, [47] held, there can be a valid partnership even between the *karta* representing the family and an undivided member of that family in his individual capacity who brings in his personal property [48] or acts as a working partner. [49] In *Ratanchand Darbarilal v CIT*, [50] the Supreme Court affirmed the position that coparceners or other members of a joint family can enter into a partnership, without a total or partial partition. A single individual by himself cannot form a partnership by acting in two different capacities: there can be no partnership in law between the same individual acting, on the one hand, as the *karta* of a joint Hindu family and, on the other, as a partner in his individual capacity, [51] even as there can be no partnership in law between the *mutawalli* of a wakf or a trustee in his representative capacity and the same individual in his personal capacity, [52] or between the guardian of minors in his representative capacity and himself in his individual capacity. [53] But the same individual can enter into a partnership with others in two capacities--in his individual capacity and in his representative capacity as the *karta* of a Hindu undivided family. [54]

The Supreme Court laid down in *Dulichand Laxminarayan v*

CIT, [55] that since a firm is not a legal entity, a firm as such cannot enter into a partnership. But, as the Supreme Court pointed out in a subsequent case, *Kylasa Sarabhaiah v CIT*, [56] if the deed shows that the constituent members of a smaller firm, and not the firm as such, had entered into a larger partnership with others, the partnership would be valid. The Allahabad High Court held in *Chandrika Prasad Ram Swarup v CIT*, [57] that where two firms purport to enter into a larger partnership, and the deed shows that the larger partnership is really a partnership between the individual members of the two firms, it would be valid. If the larger partnership is invalid, it would be assessable as an 'association of persons'. [58]

(f) Joint Family Business converted into Partnership Business. --(See post under this heading under ss 184-85, and also under **s 171** , 'Property divided among members by way of partial partition'.)

(g) Firm is an Assessable Entity. --It is well settled that under the general law a firm is not a legal person or a juridical entity. [59] But as the Supreme Court pointed out in *CIT v Figgies & Co.*, [60] and the House of Lords in *City of London IT Comrs v Gibbs*, [61] and *Latilla v IR*, [62] the technical view of the nature of partnership under the general law cannot always be taken in applying the law of income-tax. For some of the purposes of the Act a firm 'is treated as an entity distinct from the persons who constitute the firm'. [63] But as further stated by the Supreme Court in *ITO v Arunagiri*, [64] the firm is treated as an entity only for certain purpose of the Act and it is not separate juristic entity distinct from its partners. The meaning of the term 'firm' even in the context of the Act remains the same as, and the rights and duties of the partners *inter se* continue to be governed by, the provisions of the Indian **Partnership Act** . [65] Under **s 4(1)** read with **s 2(31)(iv)** a firm is a unit of assessment. [66]

An application could be made under **s 184** (now substituted) for registering a firm for the purposes of this Act. (See post under **s 2(39)** and ss 182 to 185.) Both registered and unregistered firms are assessees within the meaning of that word as defined in **s 2(7)** .

(h) Reference to Court. --(See post under ss 184-85.)

[67] ((23A) "foreign company" means a company which is not a domestic company;)

[68] ((23B) "fringe benefits" means any fringe benefits referred to in **section 115WB** ;)

(24) "income" includes--

(*i*) profits and gains;

(*ii*) dividend;

(*iia*) [69] (voluntary contributions received by a trust created wholly or partly for charitable or religious purposes or by an institution established wholly or partly for such purposes [70] (or by an association or institution referred to in clause (21), or clause (23), or by a fund or trust or institution referred to in sub-clause (*iv*) or sub-clause (*v*) [71] (or by any university or other educational institution referred to in sub-clause (*iiiad*) or sub-clause (*vi*) or by any hospital or other institution referred to in sub-clause (*iiiae*) or sub-clause (*via*)) of clause (23C), of **section 10**) [72] (or by an electoral trust). *Explanation.* --For the purposes of this sub-clause, 'trust' includes any other legal obligation;)

(*iii*) the value of any perquisite or profit in lieu of salary taxable under clauses (2) and (3) of **section 17** ;

(*iiia*) [73] (any special allowance or benefit, other than perquisite included under sub-clause (*iii*), specifically granted to the assessee to meet expenses wholly, necessarily and exclusively for the performance of the duties of an office or employment of profit;

(*iiib*) any allowance granted to the assessee either to meet his personal expenses at the place where the duties of his office or employment of profit are ordinarily performed by him or at a place where he ordinarily resides or to compensate him for the increased cost of living;)

(*iv*) the value of any benefit or perquisite, whether convertible into money or not, obtained from a company either by a director or by a person who has a substantial interest in the company, or by a relative of the director or such person, and any sum paid by any such company in respect of any obligation which, but for such payment, would have been payable by the director or other person aforesaid;

(*iva*) [74] (the value of any benefit or perquisite, whether convertible into money or not, obtained by any representative assessee mentioned in clause (*iii*) or clause (*iv*) of sub- section (1) of **section 160** or by any person on whose behalf or for whose benefit any income is receivable by the representative assessee (such person being hereafter in this sub-clause referred to as the "beneficiary") and any sum paid by the representative assessee in respect of any obligation which, but for such payment, would have been payable by the beneficiary;)

(*v*) any sum chargeable to income-tax under clauses (*ii*) and (*iii*) of **section 28** or **section 41** or **section 59** ;

(*va*) [75] (any sum chargeable to income-tax under clause (*iiia*) of **section 28** ;)

(*vb*) [76] (any sum chargeable to income-tax under clause (*iiib*) of **section 28** ;)

(*vc*) [77] (any sum chargeable to income-tax under clause (*iiic*) of **section 28** ;)

(*vd*) [78] ([79] ()the value of any benefit or perquisite taxable under clause (*iv*) of **section 28** ;)

(*ve*) [80] (any sum chargeable to income-tax under clause (*v*) of **section 28** ;)

(*vi*) any capital gains chargeable under **section 45** ;

(*vii*) the profits and gains of any business of insurance carried on by a mutual insurance company or by a co-operative society, computed in accordance with **section 44** or any surplus taken to be such profits and gains by virtue of provisions contained in the First Schedule;

(*viia*) [81] (the profits and gains of any business of banking (including providing credit facilities) carried on by a co-operative society with its members;)

(*viii*) [82] (* * * *)

(*ix*) [83] (any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever;) [84] (*Explanation* .--For the purposes of this sub-clause,--

(*i*) "lottery" includes winnings from prizes awarded to any person by draw of lots or by chance or in any other manner whatsoever, under any scheme or arrangement by whatever name called;

(*ii*) "card game and other game of any sort" includes any game show, an entertainment programme on television or electronic mode, in which people compete to win prizes or any other similar game;'.)

(*x*) [85] (any sum received by the assessee from his employees as contributions to any provident fund or superannuation fund, or any fund set up under the provisions of the **Employees' State Insurance Act** , 1948 (34 of 1948), or any other fund for the welfare of such employees;)

(*xi*) [86] (any sum received under a Keyman insurance policy including the sum allocated by way of bonus on such policy. *Explanation.* --For the purposes of this clause, [87] the expression "Keyman insurance policy" shall have the meaning assigned to it in the *Explanation* to clause (10D) of **section 10** ;)

(*xii*) [88] (any sum referred to in [89] (clause (*va*)) of **section 28** ;)

(*xiii*) [90] (any sum referred to in clause (*v*) of sub-section (2) of **section 56** ;)

(*xiv*) [91] (any sum referred to in clause (*vi*) of sub-section (2) of **section 56** ;)

(*xv*) [92] (any sum of money or value of property referred to in clause (*vii*) [93] (or clause (*viia*)) of sub-section (2) of **section 56** ;)

(*xvi*) [94] (any consideration received for issue of shares as exceeds the fair market value of the shares referred to in clause (*viib*) of sub-section (2) of **section 56** ;)

Income

Clause (24) (of 1922 Act): Income. --This clause is more systematically drafted and is far wider in scope than the corresponding clause in the 1922 Act.

Income is artificially defined to include various items. These items except the one in sub-cl (iv) are dealt with in their appropriate places under the relevant sections. The subject of business of insurance carried on by a mutual insurance association or by a co-operative society (sub-cl (vii)) is also covered under **s 4** .

The definition of income in this clause is inclusive and not exhaustive. 'Income' includes not only those things which this clause declares that it shall include, but such things as the word signifies according to its natural import. [1] **Section 2(24)** starts with words 'income includes' and would, therefore, include agricultural income even though it has not been specified as one of the items. [2] Any kind of income earned by the assessee attracts income-tax at the point of earning and tax law is not concerned with how the income is expended. The Act makes an obligation to pay tax on all income received. The Act considers income earned legally as well as tainted income alike. [3] This clause adds artificial categories to the natural connotation of 'income': its purpose is not to limit the meaning of 'income' but to widen its net [4] and it is not a mere catalogue of receipts which otherwise would not be income. [5] It is the true nature and quality of the receipt and not the head under which it is entered in the books of account that would prove decisive. [6] Anything which can be properly described as income is taxable under the Act unless exempt under one or the other provisions of the Act. In the case of mutual insurance transactions, the resultant surplus would not be income, profits or gains, according to the natural meaning of those words, whether the transactions are with members or with non-members; [7] but such surplus is deemed to be income under sub-cl (vii). [8] However, income under this clause does not include loss. [9] The concept of 'income' is discussed post under **s 4** , et seq. Unless a particular category has been specifically mentioned in the numerous clauses of **s 2(24)** , the inclusive definition of "income" will only include "real income" - that is, income which has really accrued or arisen to the assessee. The concept of real income has been discussed in **s 4** *post*, under the heading "Real and not hypothetical income chargeable".

(a) Sub-clause (ii-a): Voluntary Contributions received by Charity. --The old sub-clause excluded from the definition of 'income', voluntary contributions made to a charitable trust 'with a specific direction that they shall form part of the corpus of the trust'. The **Direct Tax Laws (Amendment) Act** , 1987 deleted the above-quoted words; and at the same time it also deleted ss 11, 12, 12A and 13. Following a public uproar the **Direct Tax Laws (Amendment) Act** , 1989 reintroduced ss 11, 12, 12A and 13, but it did not reamend **s 2(24)(ii-a)** to restore the original words expressly excluding contributions specifically made to the trust corpus. This, however, does not mean that such capital contributions are now taxable as income. Sometimes express

exclusion is by way of abundant caution, due to the over-anxiety of the draftsman to make the position clear beyond doubt. But in such a case the later omission of such express exclusion does not necessarily involve a change in the legal position. [10] **Section 12** still provides that voluntary contributions specifically made to the corpus of a charitable trust are not deemed to be income, and the same exclusion must be read as implicit in **s 2(24)(ii-a)** . It would be truly absurd to expect a charitable trust to disburse as income any amount in breach of the donor's specific direction to hold it as corpus; such breach in many cases would involve depriving charity of the benefit of acquiring a lasting asset intended by the donor. Under this sub-clause, only voluntary contributions received by such institutions as are specified therein are taxable as income. A voluntary contribution received by an institution not covered in this sub-clause is not taxable as income. [11]

(See further post under **s 12** , 'Voluntary contributions towards corpus of recipient trust'.)

(b) Sub-clauses (iii-a) and (iii-b): Special Allowance for Expenses. --Any perquisite, benefit or amenity granted to an employee was always taxable as income under sub-cl (iii) of **s 2(24)** read with **s 17** . However, sub-cll 1 (iii-a) and (iii-b) inserted by the **Direct Tax Laws (Amendment) Act** , 1989--with retrospective effect from 1962--create additional artificial categories of income. Any allowance or benefit specially granted to a salaried person to meet the expenses, wholly, necessarily and exclusively for the performance of his duties of an office or employment of profit has been held to be income. [12] Allowance given for meeting the refreshment expenses during office hours also has been held to be taxable as income. [13] The allowances treated as income by sub-cll (iii-a) and (iii-b) are exempted from tax to the extent and subject to the conditions provided in **s 10(14)** .

(c) Sub-clause (iv): Benefit or Perquisite Obtained from a Company. --This sub-clause deems to be income:

(a) the value of any benefit [14] or perquisite, whether convertible into money or not, [15] obtained from a company either by (i) a director, or (ii) any person who has a substantial interest in the company, or (iii) by a relative of the director or such person; [16] and

(b) any sum paid by a company in respect of any obligation which but for such payment would have been payable by any of the above-mentioned three classes of individuals. The sum assessable under this clause need not be the same as that disallowed to the company under **s 40(C)** [17] (now deleted).

The Madras High Court [18] has held that this sub-clause

applies irrespective of the fact whether the director is an employee director or whether the benefit received was in the nature of capital or whether there is any direct receipt in the transaction or whether there is any detriment to the company or not in the transaction. But this sub-clause does not make the value of any benefit received by the director's relative or friend taxable as the income of the director in every case. [19] Expenditure on foreign tour of a director's wife is not an income in her hands under this sub-clause if the foreign tour was undertaken at the instance of the company for its business purposes. [20] The Madras High Court has, however, held that the foreign travel expenses of the wife of a director met by the company was assessable in her hands as a benefit under **s 2(24)(iv)** even though such expenditure had been allowed as a deduction in the assessment of the company. [21] The bonus or rights shares received by a director in his capacity as a shareholder in the company are not covered by this sub-clause. [22] Cash paid for medical reimbursement will not form part of the benefit within the meaning of this clause. [23] Personal expenditure of directors that was settled through credit cards by a partnership firm would be taxable in their hands under **s 2(24)(iv)** . [24]

In order to be taxable as income under this sub-clause, the benefit should have been authorised by the company; the sub-clause does not cover the value of any un authorised benefit in respect of which the director would be liable to make restitution to the company. [25] The words 'who has a substantial interest in the company' do not qualify 'director'. Therefore, this sub-clause would apply to a director even if he is not substantially interested in the company. [26] Under cl (32), a person is deemed to have a substantial interest in the company if he is the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent. of the voting power, and it is immaterial that he is not the registered shareholder or that he is not concerned in the management of the company's business. The corresponding sub-clause in the definition of income in the 1922 Act differed from the present sub-clause in two respects: first, it deemed a person to have a substantial interest in the company only if he was concerned in the management of the company's business [27] and was also the beneficial owner of the prescribed percentage of share capital, and secondly, it did not apply at all to relatives of a director or of a person who had a substantial interest in the company. The present sub-clause applies to such relatives as fall within the definition of 'relative' in cl (41).

The items covered by this sub-clause are taxable as income irrespective of the question whether the recipient of the benefit from the company is taxable under **s 15** , **28** or **56** . Where a director obtains assets of the company at a price lower than its market value, the difference between the market value and the price

paid is taxable as a benefit under sub-cl (iv). [28]

Money embezzled is a gain to the embezzler and falls within the wider definition of income, despite a subsequent acknowledgement to pay it back. [29]

This sub-clause applies to all companies--even to companies in which the public are substantially interested. [30] It is in addition to, and not in derogation of or identical with, the definition of 'perquisite' in **s 17(2)** which is separately dealt with by sub-cl (iii) of this clause. **Section 295(2)(c)** empowers the Board to make rules for determining the value of any perquisite taxable under this Act.

Interest Free Loan or Loan at Concessional Rate. --There has been a difference of judicial opinion as to whether non-charging of interest on the debit balance of a director or of an assessee holding substantial interest in a company or giving of interest free loan to such assessees is income under this sub-clause. The Calcutta High Court [31] took the view that non-charging of interest or granting loan at a concessional rate of interest does not amount to a benefit under this sub-clause; whereas the Delhi High Court [32] took the view that non-charging of interest by a company from its directors on debit balance amounts to a benefit under this sub-clause and hence liable to tax. The above controversy has now been settled by the Supreme Court [33] which held that interest free loan obtained by a director from a company or non-charging of interest by a company on the overdrawn account of its director does not amount to any benefit or perquisite.

(See further post under **s 17(1)** , 'Fees, commissions, perquisites or profits', and under **s 17(2)** , 'Perquisite'.)

(d) Sub-clause (vb): Cash Assistance receivable from Government. --This sub-clause deems cash assistance by whatever name called received or receivable from Government as income with retrospective effect from April 1, 1967. It has set at rest the conflict of judicial opinion as to whether such receipt is a capital or revenue receipt and whether it is taxable as income under the Act. Treating cash compensatory support given to exporters as export incentive as 'income' and taxing it as business income with retrospective effect has been held to be within the legislative powers of the Parliament. [34]

(See also under **s 28** , 'Export incentives'.)

(e) Sub-clause (vi): Capital Gains Chargeable under . --This sub-clause deems as income any capital gains chargeable under **s 45** . Though the definition of income is inclusive, capital receipts do not come within the ambit of the charging section except to the extent of any capital receipt expressly covered by this sub-clause. A

capital receipt is not income under **s 2(24)** unless it is chargeable to tax as capital gains under **s 45** . Under this sub-clause, the legislature has not included all capital gains as income, but only those capital gains which are chargeable under **s 45** . Capital gains not chargeable to tax under **s 45** fall outside the definition of income in **s 2(24)** and are not taxable as a casual and non-recurring receipt under **s 10(3)** (now deleted). [35]

(f) Sub-clause (ix): Winnings from Lotteries, Crossword Puzzles, Races, Card Games and other Games of any Sort. --This sub-clause deems as income any winnings from lotteries, crossword puzzles, races including horse races, card games and other games of any sort or from gambling or betting of any form or nature whatsoever. This sub-clause is not confined to mere gambling or betting activities but would also include monies received from non-gambling or non-betting activities. [36]

The definition of 'lottery' was amended by the **Finance Act** , 2001 to include winnings from prizes awarded by draw of lots. As this amendment took effect from April 1, 2002, prizes given away prior to this date would not be taxable as lotteries and there was no obligation to deduct tax at source. [37]

The newly inserted Explanation to **s 2(24)(ix)** , which widens the definition of the word "lottery", took effect from April 1, 2002. Therefore, consumer goods given as prizes under a savings scheme promoted by the State Government could not be treated as a lottery and there was no liability to deduct tax at source. [38]

(g) Sub-clause (xii): Non-compete Fees and Exclusive Rights. --With a view to tax non-compete fees and fees for exclusivity rights, the **Finance Act** , 2002, has included within the scope of 'profit and gains of business or profession', any sum received or receivable in cash or in kind under an agreement for not carrying out activity in relation to any business, or not sharing any know-how, patent, copyright, trade-mark, licence, franchise or any other business or commercial right of similar nature or information or technique likely to assist in the manufacture or processing of goods or provision for services. However, this clause clarifies that receipts for transfer of right to manufacture, produce or process any article or thing or right to carry on any business, which are chargeable to tax under the head 'Capital gains', would not be taxable as profits and gains of business or profession. (See under 'Compensation for restraint on trading'.)

(h) Capital Employed is not Income. --Although the definition of income includes various items mentioned therein, an amount representing a certain percentage of the capital employed of an industrial undertaking under **s 80J** (now deleted) cannot be considered as income of the assessee. Thus, the relief allowed to the assessee under **s 80J** (now deleted) was not income. [39]

Similarly, if a loan was taken for acquiring a capital asset, waiver thereof would not amount to any income exigible to tax. On the other hand, if the loan was for trading purpose and was treated as such from the very beginning in the books of account the waiver thereof may result in income more so when it was transferred to the profit and loss account. [40]

(i) Reference to Court. --In the context of **s 2 (24)** , the undernoted case held that referable questions of law arose [41] and did not arise [42] under **s 256** .

[43] ((25) "Income-tax Officer" means a person appointed to be an Income-tax Officer under [44] (* *) **section 117** ;)

[45] ((25A) "India" means the territory of India as referred to in **Article 1** of the **Constitution** , its territorial waters, seabed and subsoil underlying such waters, continental shelf, exclusive economic zone or any other maritime zone as referred to in the **Territorial Waters, Continental Shelf, Exclusive Economic Zone and Other Maritime Zones Act** , 1976 (80 of 1976), and the air space above its territory and territorial waters;)

India

Clause (25A): India. --The 1922 Act used the expression 'the taxable territories' and gave an elaborate, and in some respects baffling, definition of that expression by reference to different periods in India's recent history. The present Act uses the simpler and more evocative word 'India' in place of 'the taxable territories'. (See also under **s 1(2)** .)

The definition of the term "India" was added to the Act by the Taxation Laws (Extension to Union Territories) Regulation, 1963. It was a limited definition which stated that "India" includes the territories of Dadra and Nagar Haveli, Goa, Daman and Diu, and Pondicherry. This was replaced in the **Finance Act** , 2007 with retrospective effect from 1976 with a more comprehensive definition.

Under the current definition, the term "India" has the same meaning given to it under **Article 1** of the **Constitution of India** . It is deemed to include its territorial waters, the seabed and subsoil underlying these waters, the continental shelf, the exclusive economic zone or any other economic zone that is referred to in the **Territorial Waterways, Continental Shelf, Exclusive Economic Zone and other Maritime Zones Act** , 1976. The air space above India's territory and territorial waters are included within the definition of India.

(26) "Indian company" means a company formed and registered under the **Companies Act** , 1956 (1 of 1956), and

includes--

(*i*) a company formed and registered under any law relating to companies formerly in force in any part of India [46] ((other than the State of Jammu and Kashmir and the Union territories specified in sub-clause (*iii*) of this clause));

(*ia*) [47] (a corporation established by or under a Central, State or Provincial Act ;

(*ib*) any institution, association or body which is declared by the Board to be a company under clause (17);)

(*ii*) in the case of the State of Jammu and Kashmir, a company formed and registered under any law for the time being in force in that State;

(*iii*) [48] (in the case of any of the Union territories of Dadra and Nagar Haveli, Goa, [49] Daman and Diu, and Pondicherry, [50] a company formed and registered under any law for the time being in force in that Union territory:)

Provided that the [51] (registered or, as the case may be, principal office of the company, corporation, institution, association or body) in all cases is in India;

Clause (26) (of 1922 Act): Indian Company. --The corresponding definition of Indian company in the 1922 Act was differently worded. Broadly speaking, a company is regarded as an Indian company if two conditions are fulfilled: first, if the company was formed and registered under any law relating to companies which was or is in force in any part of India, and secondly, if the registered office of the company is in India. After the amendment of this clause in 1971, a statutory corporation and any institution, association or body (whether incorporated or not) which is declared by the Board to be a company under cl (17) would be an Indian company, provided in each case its registered or principal office is in India.

[52] ((26A) "infrastructure capital company" means such company which makes investments by way of acquiring shares, or providing long-term finance to any enterprise, or undertaking wholly engaged in the business referred to in sub-section (4) of **section 80-IA** or sub- section (1) of **section 80-IAB** , or an undertaking developing and building a housing project referred to in sub-section (10) of **section 80-IB** , or a project for constructing a hotel of not less than three-star category as classified by the Central Government or a project for constructing a hospital with at least one hundred beds for patients;

(26B) "infrastructure capital fund" means such fund operating under a trust deed registered under the provisions of the **Registration Act** , 1908 (16 of 1908), established to raise moneys

by the trustees for investment by way of acquiring shares, or providing long-term finance to any enterprise, or undertaking wholly engaged in the business referred to in sub-section (4) of **section 80-IA** , or sub- section (1) of **section 80-IAB** , or an undertaking developing and building a housing project referred to in sub-section (10) of **section 80-IB** , or a project for constructing a hotel of not less than three-star category as classified by the Central Government, or a project for constructing a hospital with at least one-hundred beds for patients;)

[53] ((27) * * * *)

(28) "Inspector of Income-tax" means a person appointed to be an Inspector of Income-tax under [54] (sub-section (1)) of **section 117** ;

[55] ((28A) "interest" means interest payable in any manner in respect of any moneys borrowed or debt incurred (including a deposit, claim or other similar right or obligation) and includes any service fee, or other charge in respect of the moneys borrowed, or debt incurred, or in respect of any credit facility which has not been utilised;)

Clause (28A): Interest. --To call an amount received as interest within the definition of this clause, at least one of the conditions should be satisfied that the amount should have been received as a due on account of any money either borrowed or debt incurred. [56] Interest on delayed payment of compensation is 'interest' under this clause and consequently taxable under **s 4** of the Act. [57] A monthly amount paid to investors by a finance company under a minimum guarantee scheme is also interest under this clause. [58] Interest paid by an assessee till the date of conversion of bonds into equity shares is interest within the meaning of this clause. [59] The amounts disbursed to subscribers / members of a chit fund is not interest. [60]

[61] ((28B) "interest on securities" means--

(*i*) interest on any security of the Central Government or a State Government;

(*ii*) interest on debentures or other securities for money issued by or on behalf of a local authority or a company or a corporation established by a Central, State or Provincial Act ;)

Clause (28B): Interest on Securities. --(See under deleted ss 18 to 21, and under ss 56 and 145(1).)

[62] ((28BB) "insurer" means an insurer, being an Indian insurance company, as defined under clause (7A) of **section 2** [63]

of the **Insurance Act** , 1938 (4 of 1938), which has been granted a certificate of registration under **section 325** of that Act;)

[64] ((28C) "Joint Commissioner" means a person appointed to be a Joint Commissioner of Income-tax or an Additional Commissioner of Income-tax under sub- section (1) of **section 117** ;

Clause (28C): Joint Commissioner. --The definition of Joint Commissioner as provided under **s 2(28C)** includes Additional Commissioner. Consequently, a notice issued under **s 148** by the Additional Commissioner instead of Joint Commissioner is valid. [65]

(28D) "Joint Director" means a person appointed to be a Joint Director of Income-tax or an Additional Director of Income-tax under sub- section (1) of **section 117** ;)

(29) "legal representative" has the meaning assigned to it in clause (11) of **section 2** [66] of the **Code of Civil Procedure** , 1908 (V of 1908);

Clause (29): Legal Representative. --There was no definition of 'legal representative' in the 1922 Act. Under this Act 'legal representative' has the meaning assigned to it in the **Code of Civil Procedure** . [67] **Section 2(11)** of the Code runs as follows:

> Legal representative means a person who in law represents the estate of a deceased person, and includes any person who intermeddles with the estate of the deceased and where a party sues or is sued in a representative character the person on whom the estate devolves on the death of the party so suing or sued.

The main provisions dealing with legal representatives are contained in ss 159 and 168.

[68] ((29A) "long-term capital asset" means a capital asset which is not a short-term capital asset;

(29B) "long-term capital gain" means capital gain arising from the transfer of a long-term capital asset;)

[69] ((29BA) "manufacture", with its grammatical variations, means a change in a non-living physical object or article or thing,--

(a) resulting in transformation of the object or article of thing into a

new and distinct object or article or thing having a different name, character and use; or

(b) bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure;)

Clause (29BA): Manufacture. --The word "manufacture" is used in ss 32A, 32AB, 80HH, 80HHA, 80HHB, 80HHHBA, 80HHC, 80HHF, 80I, 80IA, 80IAB, 80IB and 80JJAA of the Act. However, this word had not been defined leading to frequent litigation. The term is well understood in the context of central excise law, where manufacture is the taxable event. This clause, introduced by the Finance (No. 2) Act, 2009 seeks to crystallise the principles well known in Central Excise Law and apply them to this Act.

In many sections under the Act, the term "manufacture" is used along with the term "production". It has been held that the term "production" has a wider connotation than the term "manufacture". [70] Under this definition, manufacture only involves changes to non-living physical objects. This would imply that poultry or agro-based industries might be excluded from the purview of this definition. The first limb of the definition in sub-cl (i) states that there must be a transformation of the object or article or thing into a new and distinct object or article with a different "name, character and use". This test was laid down in the classic judgment of Dasgupta J. in *Union of India v Delhi Cloth Mills Ltd.* [71] Sub-clause (ii) covers the bringing into existence a new and distinct object with a different chemical composition or integral structure. It has been held that the process of converting partially-oriented yarn into texturised yarn amounts to manufacture under **s 80IA** since there is a structural change in the yarn through this process. [72]

Reading the definition strictly, the development of computer software might not amount to manufacture, since no new "article or object or thing" is brought into existence. However, in a case concerned with the period before this amendment came into force, the Supreme Court held that the duplication of developed software on physical storage media amounts to manufacture under **s 80-IA** . [73] Upgradation of software, it is submitted, would not result in a product having a different name, character and use, and will not be covered under this definition.

The Supreme Court, interpreting this newly added definition, has held that the process by which excavated marble blocks are sorted, squared, polished and shined amounts to manufacture under this definition. [74]

In other sections of the Act, a different meaning has been given to the term "manufacture". For instance, Explanation 1(iii) to

s 10AA states that the term "manufacture" shall have the same meaning as assigned to it in **s 2(r)** of the **Special Economic Zones Act** , 2005. In Explanation 4 to **s 10B** , the term "manufacture" has been deemed to include cutting and polishing of precious or semi-precious stones.

(For a detailed discussion on 'manufacture', see commentary under ss 32A and 80J)

[75] ((29C) "maximum marginal rate" means the rate of income-tax (including surcharge on income-tax, if any) applicable in relation to the highest slab of income in the case of an individual [76] (, association of persons or, as the case may be, body of individuals) as specified in the Finance Act of the relevant year;)

Clause (29C): Maximum Marginal Rate. --This definition is relevant mainly for the purposes of ss 86 (first proviso), 161(1A), 164, 164A and 167B.

[77] ((29D) "National Tax Tribunal" means the National Tax Tribunal established under **section 3** [78] of the **National Tax Tribunal Act** , 2005 (49 of 2005);)

(30) "non-resident" means a person who is not a "resident" [79] (and for the purposes of **sections 92** , **93** and **168** , includes a person who is not ordinarily resident within the meaning of clause (6) of **section 6**) [80] (* * * *);

Clause (30): Non-resident. --There was no corresponding clause in the 1922 Act.

The tests of residence and ordinary residence are set out in **s 6** . An assessee may be (i) resident and ordinarily resident, (ii) resident but not ordinarily resident, or (iii) non-resident; and the liability to tax varies with the residential status. (See post under **s 5** .) This clause enacts that a person who is resident but not ordinarily resident will be treated as non-resident for the purposes of (a) applying the special provisions relating to avoidance of tax contained in ss 92 and 93, and (b) determining the residential status of a legal representative (**s 168**).

For the provisions dealing with non-residents, see post under **s 6** , 'Statutory provisions dealing with non-residents'.

(31) "person" includes--

(*i*) an individual,
(*ii*) a Hindu undivided family,
(*iii*) a company,
(*iv*) a firm,
(*v*) an association of persons or a body of individuals, whether

incorporated or not,

(*vi*) a local authority, and

(*vii*) every artificial juridical person, not falling within any of the preceding sub-clauses.

[81] (*Explanation.* --For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains;)

Person

Clause (31) (of 1922 Act): Person. --The definition of 'person' in **s 2(9)** of the 1922 Act did not exhaust the various assessable units which were separately enumerated in the charging section in that Act. In the present Act, ss 4 and 5 which are the charging sections levy tax on every person and 'person' is defined by this clause as including:

(i) an individual,

(ii) a Hindu undivided family

(iii) a company

(iv) a firm

(v) an association of persons or a body of individuals, whether incorporated or not

(vi) a local authority

(vii) every artificial juridical person, not falling within any of the preceding sub-clauses.

Thus this clause lists the seven categories of assessees or units of assessment under this Act. The Explanation provides that an association of persons, a body of individuals, a local authority or an artificial juridical person shall be deemed to be a person, whether or not any of them has the object of deriving income, profits or gains.

The definition is inclusive and not exhaustive. The word 'person' has been held to include the Crown, [82] the Government of an Indian state, [83] the Secretary of State for India when engaged in commercial enterprises, [84] and a society registered under the Societies Registration Act. [85] However, the 'estate' of a deceased person is not a person or an assessable entity; the assessment must be made on the legal representative. [86] A committee of a political party or a branch of an organisation which does not have an independent existence is not a 'person' and consequently not a taxable entity. [87]

(a) Sub-clause (i): Individual. --The expression 'individual' is narrower than the terms 'person' and 'assessee'; an individual is a person but every person need not be an individual; an individual may be an assessee but every assessee need not be an individual. [88]

Under the 1922 Act the correct view was that the word 'individual' did not mean only a human being but was wide enough to include a group of persons forming a unit, [89] and included an idol or deity [90] or a corporation created by a statute, *e.g.* a University, or a Bar Council, [91] or a State Road Transport Corporation, [92] or the trustees of a baronetcy trust incorporated by a Baronetcy Act . [93] The other view, accepted by the Federal Court of Pakistan, was that after the amendment of the Act in 1939, the word 'individual' could only mean a natural person, *i.e.* a human being. [94] Under the present Act it seems that since artificial juridical persons are placed in a separate category by themselves, the word 'individual' would mean only a natural person, *i.e.* a human being, and deities and statutory corporations should be assessed as juridical persons. (See post under 'Artificial juridical person'.)

'Individual' would include a group of individuals, [95] and a minor or a person of unsound mind. [96] The assessment may be made under **s 161(1)** on the guardian or trustee of the minor or lunatic. But 'individual' would not include a *karta* of a Hindu undivided family who acts in a representative capacity. [97]

(b) Sub-clause (ii): Hindu Undivided Family. --The relation of partnership arises from contract, while the relation of a Hindu joint family arises from status. To remove any doubts, **s 5** of the Indian **Partnership Act** expressly excludes a Hindu undivided family carrying on a family business as such from the ambit of partnership. Thus business profits made by a trading joint family are chargeable as the income of the undivided family and not as that of a firm.

The Hindu undivided family, which includes a Jain family, [1] is assessed to income- tax as a distinct entity or a unit of assessment. [2] Once a family is assessed as a Hindu undivided family, it would continue, even after partition, to be assessed as an undivided family till a finding of partition is given under **s 171** by the AO, [3] notwithstanding the fact that under the Hindu Succession Act, 1965 an individual has acquired an absolute right to a part of the family property. [4]

A Hindu is never born as an individual; in law with reference to manifold aspects, he is in the family; a Hindu who is born joins the other members of the family and this jointness is understood in terns of faith and food. [5] A joint Hindu family consists of all persons lineally descended from a common ancestor and includes their wives and unmarried daughters; while a Hindu coparcenary is

a much narrower body including only those persons who acquire by birth an interest in the joint or coparcenary property. [6] A joint Hindu family may be composed of smaller or branch joint families which may hold properties in their own right and may themselves be assessable units as distinct from the apex joint family. [7] The Privy Council observed in *Kalyanji Vithaldas v CIT*, [8] that the expression Hindu undivided family is used in this Act with reference not to one school only of Hindu law but to all schools and it would be a mistake to read it as equivalent to the narrower expression 'Hindu coparcenary'. [9]

The Supreme Court held in *Gowli Buddanna v CIT*, [10] that there need not be more than one male member to form a Hindu undivided family along with female members; [11] that even if the family is reduced to a sole surviving coparcener with other female members, the property and income belong to the joint family, and in respect of such income the tax is leviable on the joint family and not on the male member as an individual. [12] (The earlier decision of the Privy Council to the contrary in *ClT v Swamy Gomedalli*, [13] is no longer law.) This principle applies also where joint family property is partitioned and property is allotted to a coparcener who has a wife but no male issue; in such a case the income from the property is assessable as the income of the Hindu undivided family composed of the member and his wife (and daughters, if any), and cannot be included in the assessment of the member as an individual. [14] The same position prevails where a coparcener marries after the partition; on his marriage the income from the property allotted to him should be assessed as that of the Hindu undivided family consisting of him and his wife. [15] The Supreme Court held in *CIT v Veerappa Chettiar*, [16] that after the death of the last male member, the Hindu undivided family may consist of female members only. But the concept of females forming a joint family by agreement amongst themselves is contrary to the basic tenet of the Hindu law; a female Hindu cannot create by agreement with other females a Hindu undivided family and blend the property of her absolute ownership therewith. [17] A single person, male or female, cannot constitute a Hindu undivided family. [18]

In view of the **Hindu Succession Act** , 1956, the separate property of the father inherited upon intestacy by the son is to be treated as the son's separate property and not as the property of his joint family. [19]

If on partition of the family, separate shares are allotted to the *karta* , his wife and children, the existence of the Hindu undivided family comes to an end, and the share of the erstwhile *karta* becomes his separate property and the income therefrom is liable to be taxed in the status of individual. [20] The assets obtained by the assessee on partition had all the characteristics of joint family property and would continue as such even if there was a short

interval when the assessee was the sole surviving member and the time when he got married. When the assessee married, a joint Hindu family came into existence and the income from assets received on partition would become liable to be assessed only as HUF property. [21]

When a contract of the HUF was sublet by the karta to himself, the income from the contract was assessable as his income. [22]

Under the **Hindu Women's Rights to Property Act** , 1937, upon the death of a Hindu, his widow inherited, along with the son, the husband's separate property and she also acquired in the joint family property the same interest which the husband had, [23] but she took only a widow's estate in the property so inherited. The **Hindu Women's Rights to Property Act** , 1937 is now repealed by the **Hindu Succession Act** , 1956. Under the latter Act the share which the widow inherits in the coparcenary property as well as in the separate property of her deceased husband is taken by her as a full owner. [24] Further, under the **Hindu Succession Act** , 1956, if a coparcener dies leaving him surviving a relative of one of the specified categories, his share in the joint property devolves by succession on his heirs and the income therefrom is assessable in the hands of the heirs and not the joint family. [25] In a Hindu undivided family consisting of the mother and her minor sons, the mother can act as manager representing the family, and assessment and recovery proceedings may be taken against her in that capacity, [26] or the eldest adult (though minor) son who manages the family affairs may file the return and be served with notices. [27]

(c) Joint Family Income and Individual Income of a Member. --A member of a Hindu undivided family is not taxable at all in respect of any sum which he receives as such member out of the income of the family, even though the family may not have paid the tax on its income. [28] But income from separate and self-acquired property of a Hindu which has not been thrown into the common stock is assessable as the income of the individual and not as the income of a Hindu undivided family, even though the Hindu has sons from whom he is not divided, for the sons have no interest in such income. [29] A father has a right to impress his self-acquired property [30] with the character of joint family property, [31] even if the joint family does not already possess property of its own. [32] Such conversion of separate property into joint family property does not involve any transfer, [33] and can be effected merely by clear expression of intention, *e.g.* by conduct, and does not require any formalities, like a registered document, to be complied with. [34] But such intention cannot be inferred from the mere facts that the personal income and the family income are entered in the same books and the personal income is utilised for the members of the family. [35] However, where the assessee made

repeated declarations over a period of more than twelve years in his income-tax and wealth-tax returns, the assessee was deemed to have thrown his individual property into the common stock belonging to the Hindu undivided family. [36] Where a joint family is composed of smaller or branch joint families, a member is entitled to throw his self- acquired property into the hotchpot of either the main family or his own branch family. [37] Only a coparcener has the right to throw self-acquired property into the joint family hotchpot; a female member of the family has no such right. [38] But a female member can gift or bequeath her property to a joint Hindu family; [39] and there is no legal bar on a joint family to receive a gift. [40]

In *Surjitial Chhabda v CIT,* [41] the Supreme Court accepted the principle that self -acquired property can be effectively converted into joint family property even if the joint family consists of females and only one male member who throws his separate property into the family hotchpot; but the court still held that the income from such property should be assessed as the individual income of the male member on the ground that the property in its inception was not joint family property. It is submitted with respect that this decision is erroneous and that the earlier decisions of the Punjab and Haryana High Court in *CIT v Inder Singh Uppal,* [42] and the Karnataka High Court in *Ramdas Pai v CIT,* [43] holding such income to be joint family income are correct. [44] First, in the eye of Hindu law and for the purpose of taxation (apart from express statutory provisions like **s 64(2)**), personal property thrown into the family hotchpot stands on the same footing as property which is joint family property in its inception. Secondly, there is a contradiction between that part of the judgment which accepts the position that 'it became an item of joint family property for the first time when the appellant threw what was his separate property into the family hotchpot' and the conclusion that the sole male member continued to be the owner of the property and the income therefrom. [45] Thirdly, the Supreme Court observed [46] that the income from such property thrown into the family hotchpot would be joint family income after a son is born to the sole male member. But once the principle is accepted that property and its income may belong to and be assessed in the hands of a joint family consisting of females and only one male member, it would be illogical to hold that the income from the same joint family property should be treated as individual income when there is only one male member and joint family income when there are two male members. The old unsatisfactory rule which treated joint family property and its income as belonging to the sole male member and assessed them as his individual property and income was given its quietus in the cases cited ante, [47] which establish that if property is joint family property at the relevant time, on general principles the sole male member cannot be assessed as an individual in respect of such property or its income and the assessment can only be on the

joint family consisting of the sole male member and females.

The above-noted general principle of tax law that income from an individual member's property thrown into the family hotchpot is taxable as the income of the joint family, is superseded by **s 64(2)** . (See post under that section.)

The commission earned under a managing or selling agency [48] or insurance agency, [49] agreement by a *karta* or other coparcener would *prima facie* be his individual income, unless it is shown that the rights had been acquired with the aid of joint family property. [50] Offerings received by the holder of the hereditary office of the head of a religious sect are his personal income, where the functions and obligations attached to that office are personal. [51] The salary received by the treasurer of a bank, whose office requires personal responsibility, integrity and ability, would be his individual income, although joint family properties may have been furnished as security to the bank. [52] Where the wordings of the grant or a settlement deed clearly show that the amount was intended to be given only to the assessee and not to all the family members of the assessee, the income from the estate is to be taken as his individual income. [53]

A member of a trading joint family may carry on business on his personal account, in which event the profits would be his individual income and not the income of the joint family, [54] although the member might have borrowed the requisite capital out of the joint family funds [55] or the member might, after earning the income as his own, throw it into the family hotchpot. [56] Such members carrying on business on their personal account in partnership may be assessed as a firm. [57] But the mere execution of a partnership deed by the members of the family will not preclude an assessment on the undivided family as such in respect of the profits of the business. [58] If a *karta* enters into a partnership, on behalf of and as representing the joint family, with a stranger or with another member of the family, the *karta* 's share of partnership profits would be assessed in the hands of the joint family as its income. [59] The joint family which has actually received the income can be so assessed irrespective of the question whether the coparcener who entered into the partnership on behalf of the joint family had a right to represent the joint family and to enter into the partnership on its behalf. [60] If a coparcener utilises joint family funds for contributing his share of capital in the firm, he must be regarded as having entered into partnership on behalf of and as representing the family. [61]

There is no presumption that a business carried on by a member of a joint family, either by himself or in partnership with strangers, is joint family business, [62] or that such a business carried on even by the *karta* is joint family business, [63] or that the capital contributed by the individual members of a joint family came out of

the joint family funds. [64] But if there is an adequate nucleus of joint family property, the presumption arises that new acquisitions belong to the joint family. [65] Once there is a separation of one of the members of a Hindu undivided family, the presumption of Hindu law that the family is joint ceases to apply. [66] The mere fact that the profits of a business carried on by a member of a joint family are entered in the joint family accounts would not be sufficient to justify the finding that the profits constitute the income of the joint family. [67]

A reunion of a partitioned family is valid in Hindu law and as held by the Madras High Court, [68] its conditions precedent are as follows:

(i) there must have been a previous state of union. Reunion is possible only among the persons who were on an earlier date members of a Hindu undivided family;
(ii) there must have been a partition in fact;
(iii) the reunion must be effected by the parties or some of them who had made the partition; and
(iv) there must be a junction of the estate and a reunion of the property.

A *bona fide* gift of joint family property by the *karta* is only voidable and not void *ab initio* , when the gift is to a member of the family. Such a gift can be attacked only by the members of the family and not by strangers; and if it is not avoided by the members, the income from the property gifted cannot be assessed as the income of the joint family. [69] If the department has already treated the gifts as valid gift for the purpose of gift-tax, it is not open to it to assail the said gift for the purpose of income-tax and wealth-tax assessments. [70] The Supreme Court laid down in *Arunachala Mudaliar v Muruganatha Mudaliar*, [71] that where a father gifts property to his son, the language of the document and the surrounding circumstances should be looked at to determine whether he intended the son to take it exclusively for himself or whether he intended the son to hold it as ancestral property for the benefit of the son's branch of the family: there is no presumption that the father intended either the one or the other. Income from a portion of the joint family property which has been validly gifted by the *karta* to his wife would not be taxable in the hands of the joint family, even if the motive for making the gift was to reduce the tax liability of the family. [72] But a gift of ancestral immovable property by the *karta* to his wife is void [73] unless the joint family has no other male member. [74] Where a gift by the *karta* to his relation who is not a member of the joint family was held to be invalid, the income from the gifted property was held to be taxable in the hands of the joint family. [75] The father can make a valid gift by way of reasonable provision for the maintenance to the

daughter. [76]

A Hindu who declared for the purposes of the **Special Marriage Act** 1872 or 1954 that he did not profess the Hindu religion did not thereby cease to be a Hindu; the Hindu law still applied to him, with the result that he would be entitled to file a return as karta of a joint family in respect of the income from the ancestral properties. [77]

(See further post under ss 10(2) and 171.)

(d) Fee or Salary earned by Karta as Director or Partner. --Where the funds of a Hindu undivided family are invested in a company or a partnership, the dividends or share of profits are undoubtedly the income of the joint family. But in such cases even the fee, salary or other remuneration received by a member of the family as a director or partner, though it may be partially traceable to the personal exertions of the member, has been held taxable as the income of the family if (i) it is earned by detriment to the family funds, or (it) it is earned with the aid or assistance of those funds, or (iii) there is a real connection between the income and the investment of the family funds; otherwise it is taxable as the member's personal income. [78] There is considerable difficulty and room for difference of opinion in applying these principles to the facts of cases which arise in practice. Application of ancient texts to totally changed business conditions may result in attributing to the joint family that income which it disclaims and which in fairness belongs to the member who has earned it. [79]

Reviewing the case law, the Supreme Court has, in *Rajkumarsingh Hukamchandji v CIT*, [80] enunciated the following principles. The question to be considered is whether the remuneration received by the coparcener is in substance merely a mode of return made to the family because of the investment of the family funds in the business or whether it is a compensation for services rendered by the coparcener. If the income is earned essentially as a result of the funds invested, it would be the income of the family, and the fact that the coparcener has rendered some service would not change the character of the receipt. [81] On the other hand, if it is essentially a remuneration for services rendered by the coparcener, as director or otherwise, it would be the income of the coparcener, and the fact that his services were availed of by reason of his being a member of the family which had invested funds in the business or that he had obtained the qualification shares from out of the family funds would not make the receipt the income of the family. [82]

(e) Income of Impartible Estate. --An impartible estate is owned by the joint family, but the income therefrom belongs solely and absolutely to the holder of the estate for the time being. [83] Therefore the holder of an impartible estate is liable to be taxed on

the income of the estate as an individual and not as the representative of a Hindu undivided family, notwithstanding that he has sons from whom he is not divided. This is established by the decision of the Privy Council in *CIT v Krishna Kishore,* [84] setting at rest the conflict of judicial opinion on the point. Hence, if the holder was assessed on the cash basis, any income accruing during his lifetime and realised after his death would not be taxable in the hands of the Hindu undivided family; [85] nor would it be taxable as income in the hands of his personal heirs because they would receive it as capital inheritance. [86] (See further post under **s 10(2)** , 'Impartible estate'.)

(f) Reference to Court. --Whether a particular item of income belongs to an individual or to a joint family is a mixed question of fact and law. [87]

In the context of **s 2 (31)** , the undernoted cases held that referable questions of law arose [88] or did not arise [89] under **s 256** .

(g) Sub-clause (iii): Company. --(See *ante* under **s 2(17)** .)

(h) Sub-clause (iv): Firm. --See *ante* under **s 2(23)** and post under **s 2(39)** and ss 182 and 183 (now deleted) and ss 184 and 185. For the purposes of the Act a firm is treated as an entity separate and distinct from its partners. (See *ante* under **s 2(23)** , 'Firm is an assessable entity'.)

(i) Sub-clause (v): Association of Persons. --Under **s 3** of the 1922 Act, in the case of an association of persons, the department had the option to assess the tax either on the association itself as a unit of assessment, or on the members of the association as individuals in respect of their respective shares of the profits made by the association. [90] The conferment of this option which had to be judicially exercised, was valid and constitutional. [91] But once the department had made assessments on the members individually, it could not thereafter assess the same income in the hands of the association. However, the Supreme Court held in the case of *ITO v Ch Atchaiah,* [92] that there are no words in this Act which give the assessing officer an option to tax either the association of persons or its members individually; if the income is of the association of persons in law, the association along has to be taxed, and the members of the association cannot be taxed individually in respect of such income.

Prior to 1939 the phrase used in the 1922 Act was 'association of individuals', but it was changed to 'association of persons' by the Amending Act of that year. The word 'persons' has a wider connotation than 'individuals', and the amendment was made to remove any doubt as to the assessability, as a unit, of an association of which the members might not, strictly speaking, be called

'individuals'. [93] The phrase 'association of persons' is of the most comprehensive import. Under **s 3(42)** of the **General Clauses Act** , 'person' includes any company or association or body of individuals, whether incorporated or not. Therefore an 'association of persons' may have as its members, companies, firms, joint families and associations. [94] A society registered under the Societies Registration Act may be treated as an association of persons. [95]

The fact that some of the members of an association are minors does not affect the question of the assessability of the association as such. [96] Only juristic legal entities can form an 'association of persons' or a 'body of individuals' as these expression are used in this clause; and since a partnership firm is not a juristic legal entity, it was held that two firms carrying on a joint venture cannot be collectively treated as an association of persons or a body of individuals. [97]

In the case of an association of persons, **s 67A** prescribes the method of computing the shares of the members in the income of the association where the shares are determinate and known; [1] **s 86** (old **s 86(v)**) provides for cases in which such shares would be exempt in their hands; and **s 167B** provides for taxing the income of the association in its own hands where the shares of the members in such income are indeterminate or unknown.

(i) Connotation and meaning. --The words 'association of persons' are not used in any technical sense but must be construed in their plain ordinary meaning. [2]

When there is a combination of persons formed for the promotion of a joint enterprise, in other words, when co-adventurers are banded together in common action, they are assessable as an 'association of persons', when they do not in law constitute a partnership, [3] or even if there is no written agreement as between them. [4] Income from movable and immovable properties, settled by a will on two sons, will not be assessed as an AOP. [5]

Generally speaking, there can be no 'association of persons' in business unless the members of the group have joined together on their volition or free will; [6] but if the test governing an association of persons is satisfied, the circumstance that the association emerges as a result of an order of the court appointing a receiver, [7] or does business under a scheme evolved and controlled by a government authority, [8] or is necessitated by quota regulations, [9] is immaterial. After the dissolution of a firm, the income arising from the business carried on by the receiver should be assessed as belonging to an association of persons. [10]

The Explanation inserted in this clause with effect from April

1, 2002 provides that an association of persons will be deemed to be a person whether or not it is formed with the object of deriving income. However, prior thereto the law was that where the income does not result from any joint venture or joint act, assessment in the status of an association of persons would not be justified. [11] Reviewing the case law on the point, the Supreme Court held in *CIT v Indira Balkrishna,* [12] and *Mohammed Noorullah v CIT,* [13] that in order to constitute an association, persons must join in a common purpose or common action and the object of the association must be to produce income,--it is not enough that the persons receive the income jointly. Subba Rao J, speaking for the Supreme Court in *C Ag IT v Ratan Gopal,* [14] observed, 'The collection of the entire income from the estate by one of the sharers or even by a common employee will not make that income an income from a joint venture'. Likewise , the mere appointment of a common agent, manager or lessee will not make the owners assessable as an association of persons. [15]

A joint venture by four companies, executing a joint development agreement, is to be assessed as an association of persons. [16]

Co-heirs, co-legatees or co-donees joining together in a common purpose or action would be chargeable as an association of persons, [17] but not if they merely receive income jointly. [18] Trustees of a fixed (specific) trust cannot be considered as an association of persons or body of individuals. [19] In the case of a trust, the assessment may be either on the trustees or on the beneficiaries. Co-trustees or co-receivers cannot be assessed as an association of persons merely because they are more than one in number. The status in which they should be assessed depends upon the status of the beneficiaries they represent. (See post under **s 161** , 'Assessment on representative assessee where several persons are beneficially entitled to income: Joint representative assessees'.) A non-resident sports association is an association of person within the meaning of this clause. [20]

(ii) Co-owners. --In the case of co-owners of property, if their shares are not definite and ascertainable they may be assessable as an association of persons. [21] Where the shares are definite and ascertainable, mere co-ownership is not sufficient to justify an assessment as on an association of persons. [22] The members of a formerly undivided Mitakshara family, after a partition recognised under **s 171** , cannot be assessed as an association of persons but must be individually assessed in respect of their shares, [23] even if, in the case of a share in a firm, the erstwhile *karta* continues as a partner and receives income from the firm on behalf of the divided members. [24] Similarly, if a receiver appointed in a partition suit of joint family properties does not carry on any income-producing activities, the members of the family would not constitute an

association of persons as contemplated by the Act; the department may assess each individual co-owner separately on his share of the income or may levy the tax upon the receiver under **s 161(1)** in the same amount as would be leviable upon each co-owner individually. [25] But co-ownership coupled with other indicia of joint enterprise would make the co-owners assessable as an association of persons. [26] Thus where persons join together to purchase and sell land as a trading transaction [27] or to acquire, hold and manage property jointly for the purpose of producing income, fall to be charged as an association of persons. [28] But this general rule must be read subject to the provisions of **s 26** which provides that where house property is owned by two or more persons and their respective shares are definite and ascertainable, such persons should not in respect of such property be assessed as an association of persons but each of them should be individually assessed in respect of his share in the income from the property. [29]

Therefore in the case of house property (which alone is covered by **s 26**) if the shares of the co-owners are definite and ascertainable, the co-owners should be assessed not as an association of persons but individually, even though the property may be jointly owned, jointly managed and jointly developed by them. [30] (See post under **s 26** , 'Assessment of co-owners'.)

(iii) Illegal Association. --In order to constitute an association it is not necessary that there should be any mutual rights or obligations among the members enforceable in a court of law. [31] Illegality or invalidity in the constitution of an association does not affect its liability to tax or its chargeability as a unit of assessment. [32] A partnership which is illegal or otherwise void may be assessed as an association of persons. [33] An association of 133 persons carrying on business without being incorporated as required by the Indian company law would nevertheless be chargeable as an association of persons. [34] (See further post under **s 4** , 'Income tainted with illegality'.)

(iv) Existence of 'Association' Depends on the Facts of each Case. --The question whether there is an association of persons must be decided upon the facts and circumstances of each case. [35]

(v) Joint Ventures or Consortium. --The position of law in the context of joint ventures has been examined in the undernoted ruling. [36] In the facts of that case, it was found that the unincorporated joint venture (whose members were all incorporated companies) was not an "association of persons" (AOP). Three factors were found to be particularly helpful in coming to this conclusion. *First* , the nature of the work assigned to each member of the venture under the agreement was substantially different. *Secondly,* the agreement between the members specifically provided that no new legal entity or partnership was being created

by the members. *Thirdly,* members carried out their functions separately and independently of each other. The ruling illustrates the importance of due weight being accorded to the agreement between the parties in determining whether or not a venture carried out by several persons ought to be treated as an 'association of persons' or not. [37]

Large projects are often executed through a consortium of foreign and Indian companies. In most cases, a joint venture agreement is signed and whether the joint venture partners are an AOP will depend upon the terms of the contract and the role of each of the partners. If the contract requires each party to perform its obligation and receive payments independently of each other, the identity of each of them is preserved. The parties cannot be treated as an AOP merely because one of them is entrusted with supervisory responsibility. [38] But where three contracting parties were jointly and severally responsible and the income was that of the joint venture to be distributed in a specified ratio later, the parties constituted an AOP. [39] The latter decision has been distinguished by the AAR in another case [40] involving a consortium of four parties. The following features showed that there was no AOP:-

(i) the scope of the work was specifically defined and mutually exclusive;
(ii) there was no interchangeability or overlapping of work;
(iii) the contract expressly stipulated that there was no intention to create a partnership, a legal entity or an AOP;
(iv) profits and losses were borne by the individual parties with no common expenditure being incurred by them.

The imposition of joint and several responsibility was, in the above case, held to be only a safeguard. It is thus important to carefully draft joint venture contracts keeping in mind the rulings of the AAR on this point.

(j) Body of Individuals. --The words 'body of individuals', placed in the same sub- clause in juxtaposition with 'association of persons', were not in the 1922 Act. They take their colour from the words which precede them. The essence of the concept of an association of persons' is persons joining in common action with the object of producing income, [41] and the same essential element must be present to constitute 'a body of individuals'. This view was earlier also taken by the Bombay High Court in *CIT v Desale* , [42] the Allahabad High Court in *CIT v Vimla Lal,* [43] and the Kerala High Court in *CIT v Parukutty Mooppitamma.* [44] However, the Explanation inserted in this clause with effect from April 1, 2002 provides that a body of individuals will be deemed to be a person whether or not it is formed with the object of derived income.

Having regard to the context in which the words 'body of individuals' occur, they cannot be construed as entitling the department to club together the income of individuals with definite shares and assess them as a unit of assessment, in cases where such an assessment was not permissible under the 1922 Act. For instance, where co-heirs inherit shares or securities and hold them equally as tenants-in-common, they should be assessed separately and cannot be assessed as a unit of assessment merely because they receive the income jointly. [45] This ruling of the Supreme Court in *CIT v Indira Balkrishna,* [46] and *Mohammed Noorullah v CIT,* [47] is not superseded by the expansion of 'an association of persons' into 'an association of persons or a body of individuals'.

The Madras High Court held in *CIT v Deghamwala Estates,* [48] that co-owners with specific shares selling their property cannot be assessed to tax on capital gains as a body of individuals. A similar view has been taken by the Kerala High Court which held in *CIT v Suresh Chandran,* [49] that sales of lands made under a single instrument of transfer to four individuals who got absolute title to separate properties cannot be treated as a single sale to a body of individuals.

The debatable question is whether minors who find themselves--with or without an adult--to be co-owners of a business, *e.g.* , on inheritance, without any common action or volition of their own, should be assessed as a 'body of individuals', despite the fact that their shares are specific and determinate. The Andhra Pradesh High Court [50] has taken the view that 'a combination of individuals who have a unity of interest but who are not actuated by a common design, and one or more of whose members produceincome for the benefit of all' can be assessed as a 'body of individuals'. In that case, on the death of an individual his widow and two minor children who succeeded to his business were held assessable as a 'body of individuals'. The Supreme Court [51] has on similar facts held that the income from business was assessable as belonging to a body of individuals. Similarly, it has also held that after the dissolution of a firm, its erstwhile partners are assessable as a body of individual. [52] In a case where on the death of an individual, his widow and children became entitled to his share in a firm, the Madras High Court held that such income was assessable in the status of 'body of individuals'. [53]

Under **s 5A** of the Act, introduced with retrospective effect from April 1, 1963, Husband and wife governed by the Portuguese law are assessable, not as an association of persons or body of individuals, but separately in respect of their shares in income from the property of their communion. (See under **s 5A** .)

Since Christians are governed by the **Indian Succession Act** , 1925, the entire holding of land inherited is to be equally divided among the legal heirs, and the income from the land is not

asessable in their hands as an association of persons. [54]

Co-trustees or co-receivers cannot be assessed as a body of individuals merely because they are more than one in number. The status in which they should be assessed depends upon the status of the beneficiaries they represent. (See post under **s 161** , 'Assessment on representative assessee where several persons are beneficially entitled to income: Joint representative assessees'.)

(See also ss 67A, 86(v) and 167B.)

(k) Sub-clause (vi): Local Authority. --Local authority is a unit of assessment. It means a municipal committee, district board, body of port commissioners or other authority legally entitled to, or entrusted by the government with the control or management of a municipal or local fund. [55] A 'local authority' within this sub-clause includes a municipality [56] and an agricultural market committee appointed under a state law, [57] but not a state road transport corporation. [58] (For the exemption enjoyed by a local authority in respect of its income, see post under **s 10(20)** .) The Explanation inserted in this clause with effect from April 1, 2002 provides that a local authority will be deemed to be a person whether or not it is established with the object of deriving income.

(1) Sub-clause (vii): Artificial Juridical Person. --There was no such separate category of assessees under the 1922 Act, with the result that statutory corporations were held assessable as 'individuals'. (See *ante* under 'Individual'.) Under the present Act a statutory corporation, [59] like a Bar Council, [60] or an idol or deity would be assessable in the status of artificial juridical person and not as an individual. A society registered under the Co-operative Societies Act is a juridical person. [61] The Explanation inserted in this clause with effect from April 1, 2002 provides that an artificial juridical person will be deemed to be a person whether or not it is formed with the object of deriving income.

(32) "person who has a substantial interest in the company", in relation to a company, means a person who is the beneficial owner of shares, not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits, carrying not less than twenty per cent. of the voting power;

Clause (32) (Part of of 1922 Act): 'Person who has a Substantial Interest in the Company'. --The corresponding provision in the 1922 Act was materially different. It required that (in addition to beneficial ownership of shares) the person must be concerned in the management of the business of the company, whereas there is no such condition in the present definition.

In order to bring an individual within the definition of 'person who has a substantial interest in the company' the only condition is

that he should be the beneficial owner of shares (not being shares entitled to a fixed rate of dividend whether with or without a right to participate in profits) carrying not less than twenty per cent. of the voting power. [62] The term 'voting power' in this clause denotes the total voting strength exercisable by all the equity shareholders in a company. [63] Beneficial ownership, and not legal ownership, of shares is the criterion. Thus the registered holder of even the majority of equity shares would not fall within this definition if he has no beneficial interest in the shares; and conversely, a person who is beneficially entitled to twenty per cent. or more of the equity capital would be covered by this definition even if he is not the registered holder of any shares. [64] The term 'person' includes all categories of persons specified in **s 2(31)** , including a company. [65]

(33) "prescribed" means prescribed by rules made under this Act;

Clause (33): Prescribed. --This clause which defines the word 'prescribed' as meaning 'prescribed by rules made under this Act' may be taken as legislative acceptance of the general principles of construction that 'prescribed' means prescribed by rules. [66]

(34) "previous year" means the previous year as defined in **section 3** ;

(35) "principal officer", used with reference to a local authority or a company or any other public body or any association of persons or any body of individuals, means--

(*a*) the secretary, treasurer, manager or agent of the authority, company, association or body, or

(*b*) any person connected with the management or administration of the local authority, company, association or body upon whom the [67] (Assessing Officer) has served a notice of his intention of treating him as the principal officer thereof;

Clause (35) (of 1922 Act): Principal Officer. --The definition in the 1922 Act was the same except that the present sub-cl (b) is more restricted in its scope than the corresponding provision in the earlier Act. The present sub-cl (b) requires a person to be connected with the management or administration of the assessable entity in order that he may be treated as its principal officer, whereas under the 1922 Act it was sufficient if he was merely connected with the assessable entity. [68]

Principal officer, in reference to a local authority or other public body, a company, or a body or association of persons, means its secretary, treasurer, manager [69] or agent. Further, the AO may

serve upon any person connected with the management or administration of such assessable entity a notice of his intention of treating him as the principal officer, and such person would thereupon become the principal officer for the purposes of this Act. [70] In the case of a company which is being wound up, the AO would be entitled, without leave of the winding up court, [71] to serve upon the liquidator a notice of his intention of treating him as the principal officer and to call upon him to make a return of income. [72]

Before issuing a show-cause notice under **s 276B** read with **s 278B** , there is no need to issue a separate notice or communication to the director of a company to treat them as "Principal officers". [73]

(36) "profession" includes vocation;

Clause (36): Profession. --The 1922 Act used the expression 'profession or vocation' in different sections; whereas the present statute achieves the same result by using the word 'profession' throughout the Act and indicating in this definition clause that profession includes vocation. But the word 'profession' has to be understood as distinct and separate from the word 'business'. [74] (See further under **s 28** , 'Business, profession or vocation'.)

[75] ((36A) "public sector company" means any corporation established by or under any Central, State or Provincial Act or a Government company as defined in **section 617** [76] of the **Companies Act** , 1956 (1 of 1956);)

(37) "public servant" has the same meaning as in **section 21** [77] of the **Indian Penal Code** (XLV of 1860);

Clause (37) (of 1922 Act): Public Servant. --In this Act, as in the 1922 Act, public servant has the same meaning as in **s 21** of the **Indian Penal Code** 1860. The definition in that Code runs as follows:

> The words 'public servant' denote a person falling under any of the descriptions hereinafter following, namely: *First* --(Repealed by the **Adaptation of Laws Order** 1950.) *Second* --Every Commissioned Officer in the Military, Naval or Air Forces of India; *Third* --Every Judge including any person empowered by law to discharge, whether by himself or as a member of any body of persons, any adjudicatory functions; *Fourth* --Every officer of a Court of Justice (including a liquidator, receiver or commissioner) whose duty it is, as such officer, to investigate or report on any matter of law or fact, or to

make, authenticate, or keep any document, or to take charge or dispose of any property, or to execute any judicial process, or to administer any oath, or to interpret, or to preserve order in the Court, and every person specially authorised by a Court of Justice to perform any of such duties; *Fifth* --Every juryman, assessor or member of a panchayat assisting a Court of Justice or public servant; *Sixth* --Every arbitrator or other person to whom any cause or matter has been referred for decision or report by any Court of Justice, or by any other competent public authority; *Seventh* --Every person who holds any office by virtue of which he is empowered to place or keep any person in confinement; *Eighth* --Every officer of the Government whose duty it is, as such officer, to prevent offences, to give information of offences, to bring offenders to justice, or to protect the public health, safety or convenience; *Ninth* --Every officer whose duty it is, as such officer, to take, receive, keep or expend any property on behalf of the Government, or to make any survey, assessment or contract on behalf of the Government, or to execute any revenue-process, or to investigate, or to report, on any matter affecting the pecuniary interests of the Government, or to make, authenticate or keep any document relating to the pecuniary interests of the Government, or to prevent the infraction of any law for the protection of the pecuniary interests of the Government; *Tenth* --Every officer whose duty it is, as such officer, to take, receive, keep or expend any property, to make any survey or assessment or to levy any rate or tax for any secular common purpose of any village, town or district, or to make, authenticate or keep any document for the ascertaining of the rights of the people of any village, town or district; *Eleventh* --Every person who holds any office in virtue of which he is empowered to prepare, publish, maintain or revise an electoral roll or to conduct an election or part of an election; *Twelfth* --Every person--

(a) in the service or pay of the Government or remunerated by fees or commission for the performance of any public duty by the Government;

(b) in the service or pay of a local authority, a corporation established by or under a Central, Provincial or State Act or a Government company as defined in **section 617** of the **Companies Act** , 1956 (1 of 1956).

Illustration A Municipal Commissioner is a public servant.

Explanation 1 --Persons falling under any of the above descriptions are public servants, whether appointed by the Government or not. *Explanation 2* --Wherever the words 'public servant' occur, they shall be understood of every person who is in actual possession of the situation of a public servant, whatever legal defect there may be in his right to hold that situation.

Explanation 3 --The word 'election' denotes an election for the purpose of selecting members of any legislative, municipal or other public authority, of whatever character, the method of selection to which is by, or under, any law prescribed as by election.

[78] ((37A) "rate or rates in force" or "rates in force", in relation to an assessment year or financial year, mean--

(*i*) for the purposes of calculating income-tax under the first proviso to sub-section (5) of **section 132** , or computing the income-tax chargeable under sub-section (4) of **section 172** or sub-section (2) of **section 174** or **section 175** or sub-section (2) of **section 176** or deducting income-tax under **section 192** from income chargeable under the head "Salaries" [79] (* * * *) or [80] (computation of the "advance tax" payable under Chapter XVII-C [81] (in a case not falling under **section 115A** or [82] (**section 115B** [83] (or **section 115BB** or **section 115BBB** or **section 115E**) or **section 164** or **section 164A** [84] (* *))) [85] (or **section 167B**), the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year, and for the purposes of computation of the "advance tax" payable under Chapter XVII-C [86] (in a case falling under **section 115A** or [87] (**section 115B 83** (or **section 115BB** or **section 115BBB** or **section 115E**) or **section 164** or **section 164A 84** (* *)) 85(or **section 167B**), the rate or rates specified in **section 115A** or 87(**section 115B** 83(or **section 115BB** or **section 115BBB** or **section 115E**) or **section 164** or **section 164A** [88] (* *) [89] (or **section 167B**), as the case may be,)) or the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year, whichever is applicable);

(*ii*) for the purposes of deduction of tax under **sections 193** , **194** , [90] (194A, [91] (194B, 194BB,)) [92] (and 194D), the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year;)

(*iii*) [93] (for the purposes of deduction of tax under **section 195** , the rate or rates of income-tax specified in this behalf in the Finance Act of the relevant year or the rate or rates of income-tax specified in [94] (an agreement entered into by the Central Government under **section 90** , or an agreement notified by the Central Government under **section 90A** , whichever is applicable by virtue of the provisions of **section 90** , or **section 90A** , as the case may be;))

(38) "recognised provident fund" means a provident fund which has been and continues to be recognised by the [95] (Chief Commissioner or Commissioner) in accordance with the rules contained in Part A of the Fourth Schedule, and includes a provident fund established under a scheme framed under the Employees' **Provident Funds Act** , 1952 [96] (XIX of 1952);

[97] ((39) * * * *)

Clause (39)(now deleted) (of 1922 Act): Registered Firm. --The concept of a registered firm under this Act was the same as under the 1922 Act. This concept is now omitted with the

introduction of the new procedure for taxation of firms.

If a firm is constituted under an instrument of partnership specifying the individual shares of the partners, an application could be made under **s 184** (now substituted) of this Act to the AO on behalf of such firm for registration for the purposes of this Act. (For the difference between registered and unregistered firms, see post under ss 182-83, 'Assessment of registered and unregistered firms'.)

(40) "regular assessment" means the assessment made under [98] (sub-section (3) of **section 143**) or **section 144** ;

Clause (40): Regular Assessment. --There was no corresponding definition in the 1922 Act. 'Regular assessment' means an assessment made under **s 143** or **144** , in contra distinction to a self assessment under **s 140A** , a provisional assessment under **s 141** before its deletion in 1971, and an assessment or reassessment under **s 147** . [1] (See further post under **s 139(8)** , 'Interest'; under **s 214** , 'Interest payable by Government'; under ss 215-7, 'Interest payable by assessee'; and under **s 273** , 'Penalty for false estimate of or failure to pay advance tax'.)

(41) "relative", in relation to an individual, means the husband, wife, brother or sister or any lineal ascendant or descendant of that individual;

Clause (41) (Part of Explanation (1)(b)(iii) to of 1922 Act): Relative. --There was no general definition of the word 'relative' in the 1922 Act, but **s 23A** defined it, for the limited purpose of that section, in the same terms as are used in this clause. For the purpose of ss 11 to 13, Explanation 1 to **s 13** defines 'relative' more extensively than this clause does. The definition of 'relative' in this clause would be relevant for provisions such as ss 2(24)(iv), 4OA(2), 269Q, 269UO and 288(2)(vi-a).

[2] ((41A) "resulting company" means one or more companies (including a wholly owned subsidiary thereof) to which the undertaking of the demerged company is transferred in a demerger and the resulting company in consideration of such transfer of undertaking, issues shares to the shareholders of the demerged company and includes any authority or body or local authority or public sector company or a company established, constituted or formed as a result of demerger;)

(42) "resident" means a person who is resident in India within the meaning of **section 6** ;

[3] ((42A) [4] ("short-term capital asset" means a capital asset held by an assessee for not more than [5] (thirty-six months)

immediately preceding the date of its transfer:))

[6] (*Provided* that in the case of a share held in a company [7] (or any other security listed in a recognised stock exchange in India or a unit of the Unit Trust of India established under the **Unit Trust of India Act** , 1963 (52 of 1963) [8] , or a unit of a Mutual Fund specified under clause (23D) of section 10), [9] (or a zero coupon bond) the provisions of this clause shall have effect as if for the words "thirty-six months", the words "twelve months" had been substituted.)

[10] (*Explanation 1*).--(*i*) In determining the period for which any capital asset is held by the assessee--

(*a*) in the case of a share held in a company in liquidation, there shall be excluded the period subsequent to the date on which the company goes into liquidation;

(*b*) in the case of a capital asset which becomes the property of the assessee in the circumstances mentioned in [11] (sub-section (1)) of **section 49** , there shall be included the period for which the asset was held by the previous owner referred to in the said section;

(*c*) [12] (in the case of a capital asset being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a transfer referred to in clause (*vii*) of **section 47** , there shall be included the period for which the share or shares in the amalgamating company were held by the assessee;)

(*d*) [13] (in the case of a capital asset, being a share or any other security (hereafter in this clause referred to as the financial asset) subscribed to by the assessee on the basis of his right to subscribe to such financial asset, or subscribed to by the person in whose favour the assessee has renounced his right to subscribe to such financial asset, the period shall be reckoned from the date of allotment of such financial asset;

(*e*) in the case of a capital asset, being the right to subscribe to any financial asset, which is renounced in favour of any other person, the period shall be reckoned from the date of the offer of such right by the company or institution, as the case may be, making such offer;)

(*f*) [14] (in the case of a capital asset, being a financial asset, allotted without any payment and on the basis of holding of any other financial asset, the period shall be reckoned from the date of the allotment of such financial asset;)

(*g*) [15] (in the case of a capital asset, being a share or shares in an Indian company, which becomes the property of the assessee in consideration of a demerger, there shall be included the period for which the share or shares held in the demerged company were held by the assessee;)

(*h*) [16] (in the case of a capital asset, being trading or clearing rights of a recognised stock exchange in India, acquired by a person

pursuant to demutualisation, or corporatisation of the recognised stock exchange in India as referred to in clause (*xiii*) of **section 47** , there shall be included the period for which the person was a member of the recognised stock exchange in India immediately prior to such demutualisation or corporatisation;

(*ha*) in the case of a capital asset, being equity share or shares in a company allotted pursuant to demutualisation or corporatisation of a recognised stock exchange in India, as referred to in clause (*xiii*) of **section 47** , there shall be included the period for which the person was a member of the recognised stock exchange in India immediately prior to such demutualisation or corporatisation;)

(*hb*) [17] (in the case of a capital asset, being any specified security or sweat equity shares allotted or transferred, directly or indirectly, by the employer free of cost, or at concessional rate to his employees (including former employee or employees), the period shall be reckoned from the date of allotment, or transfer of such specified security or sweat equity shares;)

(*ii*) In respect of capital assets other than those mentioned in clause (*i*), the period for which any capital asset is held by the assessee shall be determined subject to any rules which the Board may make in this behalf.)

[18] (*Explanation 2.* --For the purposes of this clause, the expression "security" shall have the meaning assigned to it in clause (*h*) of **section 2** [19] of the **Securities Contracts (Regulation) Act** , 1956 (42 of 1956);)

[20] (*Explanation* 3.--For the purposes of this clause, the expressions "specified security" and "sweat equity shares" shall have the meanings respectively assigned to them in the *Explanation* to clause (*d*) of sub- section (1) of **section 115WB** ;)

Clause (42A): Short-term Capital Asset. --The 1922 Act did not make any distinction between short-term capital assets and other capital assets. A short-term capital asset means a capital asset held [21] by an assessee for not more than thirty-six months [22] (in the case of shares, twelve months from the assessment year 1988-89) immediately preceding the date of its transfer.

Where the assessee enters into an agreement to purchase property and more than three years thereafter transfers all his rights under that agreement, the transfer is of a long-term capital asset, *viz* his contractual right, even if in the meantime he has obtained possession of the property but without any conveyance being executed in his favour. [23] Where the assessee purchases two capital assets at one consolidated price he is entitled to bifurcate the same, and when one of them is sold, the benefit in respect of a gain that could be considered as a long-term capital gain, cannot be denied to him. [24] It appears that the correct test in this regard is whether the

capital assets are distinct and independently identifiable. Thus, where certain lands and buildings thereon are sold together, the land should be treated as an independent and identifiable capital asset and it continues to remain so even after construction of the building thereon. The capital gains on the land and building must be computed separately. [25]

The assessee who is allotted bonus shares should be taken to hold them from the date they are issued and not from the date he acquired the original shares in respect of which the bonus shares are issued. [26] Similarly, the debenture holder who is allotted shares in lieu of debentures should be taken to hold the shares from the date the shares, and not the debentures, were acquired. [27] Clause (i)(a) of the Explanation provides that in calculating the period for which a share in a company in liquidation was held by the assessee, the period after the date of liquidation must be excluded. In other words, the assessee must hold the share for more than twelve months prior to the commencement of the liquidation of the company in order that the share may not be treated as a short-term capital asset. (**Section 46** provides that a distribution of money or other assets by a company in liquidation is assessable as capital gains in the hands of the shareholder.) Gold and Gold Bonds are different assets; therefore, where the assessee receives gold on the redemption of Gold Bonds and later sells it, he should be taken to hold the gold from the date the bonds are redeemed. [28]

Clause (i)(b) of the Explanation enacts that where the capital asset became the property of the assessee in any of the cases covered by **s 49(1)** (partition of joint family, gift, inheritance, etc), the period for which the asset was held by the previous owner must be added to the period for which the asset was held by the assessee in determining whether the asset had been held for more than the prescribed period.

Explanation (i) dealing with determination of the period for which any capital asset is held by the assessee also includes provisions for additional specific cases for certain shares, other securities, financial asset or right to subscribe to any financial asset, shares received upon demerger, trading or clearing rights or shares received upon demutualisation or corporatisation of a recognised stock exchange. The mode of computation of capital gains is contained in **s 48** .

[29] ((42B) "short-term capital gain" means capital gain arising from the transfer of a short-term capital asset;)

[30] ((42C) "slump sale" means the transfer of one or more undertakings as a result of the sale for a lump sum consideration without values being assigned to the individual assets and liabilities in such sales.

Explanation 1. --For the purposes of this clause, "undertaking" shall have the meaning assigned to it in *Explanation 1* to clause (19AA).

Explanation 2. --For the removal of doubts, it is hereby declared that the determination of the value of an asset or liability for the sole purpose of payment of stamp duty, registration fees or other similar taxes or fees shall not be regarded as assignment of values to individual assets or liabilities;)

Clause (42C): Slump Sale . --This definition was inserted by the **Finance Act** , 1999 along with the new **s 50B** which contains special provision for computation of capital gains in the case of a slump sale. A slump sale means the transfer of one or more undertakings as a result of the sale for a lumpsum consideration without values being assigned to the individual assets and liabilities in such sales. **Section 50B** provides that the profits and gains arising from a slump sale shall be chargeable to income-tax as capital gains arising from transfer of long-term capital assets in the previous year in which the transfer takes place. However, the profits and gains arising from such transfer of one or more undertakings held for less than thirty-six months shall be deemed to be short-term capital gains.

[31] ((43) "tax" in relation to the assessment year commencing on the 1st day of April, 1965, and any subsequent assessment year means income-tax chargeable under the provisions of this Act, and in relation to any other assessment year income-tax and super-tax chargeable under the provisions of this Act prior to the aforesaid date [32] (and in relation to the assessment year commencing on the 1st day of April, 2006, and any subsequent assessment year includes the fringe benefit tax payable under section 115WA);

Clause (43): Tax . --Tax means income-tax chargeable under the provisions of this Act and does not include tax levied under any other Act or a foreign tax. [33]

Tax does not include interest. Thus, when deposit of tax is made a condition precedent in some situations (say, under **s 249**), this does not include the deposit of interest levied under the ss 234B and 234C. [34] A distinction between tax chargeable under this Act and that levied in a foreign country is clearly brought out in **s 90** .

(43A) "tax credit certificate" means a tax credit certificate granted to any person in accordance with the provisions of Chapter XXII-B and any scheme made thereunder;)

[35] ((43B)****)

[36] ((44) "Tax Recovery Officer" means any Income-tax

Officer who may be authorised by the Chief Commissioner or Commissioner, by general or special order in writing, to exercise the powers of a Tax Recovery Officer [37] (and also to exercise or perform such powers and functions which are conferred on, or assigned to, an Assessing Officer under this Act and which may be prescribed);)

Clause (44): Tax Recovery Officer. --There was no corresponding definition in the 1922 Act. Unlike the 1922 Act, the present Act contains a self-contained Code for recovery of tax. The material provisions for recovery are contained in ss 220 to 232, the Second and Third Schedules, and the **Income-tax (Certificate Proceedings) Rules** 1962.

Clause (44) defines 'Tax Recovery Officer' as meaning any ITO who may be authorised by the CIT to exercise the powers of a TRO. [38] **Rule 19A** of the Second Schedule enables the TRO to delegate any of his functions as TRO to subordinate officers in certain circumstances.

(45) "total income" means the total amount of income referred to in **section 5** , computed in the manner laid down in this Act;

Clause (45) (of 1922 Act): Total Income. --This definition is the same as in the 1922 Act.

The definition of total income in this sub-section involves two ingredients--(a) the income must comprise the total amount of income, profits and gains referred to in **s 5** , and (b) it must be computed in the manner laid down in the Act. [39] The manner of computation laid down by the Act forms an integral part of the definition of 'total income'. The correct method of approach is to treat nothing as being charged to tax until by the process of computation laid down by the Act the status of income, profits and gains emerges. [40]

Subject to the provisions of the Act, **s 4** charges the total income of an assessee to income-tax. **Section 5** defines total income in terms of residence. A non-resident's total income comprises only the income which accrues or is received or is deemed to accrue or to be received in India, while a resident's total income comprises income accruing in any part of the world. After determining the question of the assessee's residence, the items of income includible in his total income must be ascertained with reference to **s 5** and then the income must be computed in the manner laid down in the Act. There are included in an assessee's total income, items which may not be his income at all in fact or under the general law. [41] Total income is distinct from the estimated income, upon the basis of which, advance tax is paid. Advance tax is based on estimated income, and, hence, it cannot result in the disclosure of the total income assessable and

chargeable to tax. [42] Tax deducted at source is regarded as income received and has to be included in the total income under **s 198** , while credit for the tax deducted is given to the assessee under **s 199** . **Rule 12** prescribes the form of return of total income which must be filled in by the assessee.

Income Exempt from Tax. --Exemption granted under this Act is of two kinds. Certain incomes are exempt from charge and are also excluded from the assessee's total income, *e.g.* the income exempted under ss 10, 10A, 10B, 11, 12, 13A, and some items in notification dated March 21, 1922 issued under **s 60** of the 1922 Act [43] or under **s 293A** of this Act. Certain other incomes are exempted from income-tax but they are to be included in the assessee's total income, *e.g.* the sums exempted under **s 86** which are expressly declared by **s 66** to be includible in the assessee's total income. Thus income which may itself be exempt from tax may yet form part of the assessee's 'total income'. Therefore it follows that the total income of an assessee is not necessarily wholly subject to tax. [44] **Section 110** provides the mode of computing the tax in cases where exempted income is included in the total income.

Under **s 14A** , for the purposes of computing the total income under chapter IV dealing with computation of income, it is provided that no deduction shall be allowed in respect of expenditure incurred by the assessee in relation to income which does not form part of the total income under this Act.

The effect of including exempted income in the assessee's total income is mainly twofold. First, the rate of tax payable by the assessee is determined with reference to the total income and therefore exempted income which is included in the total income would affect the rate of tax applicable to the chargeable portion of the total income. Secondly, in several cases calculations have to be made with reference to the total income; and income which is exempted from tax but included in the total income is to be taken into consideration for this purpose.

Although agricultural income is exempt from tax under **s 10(1)** and is therefore not includible in the total income under the scheme of this Act, since 1973 the annual Finance Acts have superseded this scheme by providing for inclusion of agricultural income in the total income for the limited purpose of determining the rate applicable to the taxable income.

Where the Act grants exemption from tax in respect of a certain sum, that sum does not form part of the total income unless there is some other provision in the Act making it includible in the total income. In *CIT v Raiji,* [45] Chagla CJ said, with reference to the 1922 Act:

> The scheme is that wherever one finds an exemption or exclusion from payment of tax, the exemption or exclusion also operates for the purpose of computing the total income. Not only is the sum not liable to tax, but it is also not to form part of the total income for the purpose of determining the rate. When the legislature intends that certain sums, although not liable to tax, should be included in the total income, it expressly so provides, as it is done in **section 16** .

Section 16 of the 1922 Act corresponds to **s 66** of this Act, and the scheme of this Act is the same.

[46] ((46)****)

Deleted Clause (46): (of 1922 Act): Total World Income. --The definition of 'total world income' in this clause (which was deleted in 1965) was the same as in the 1922 Act.

Prior to the deletion of ss 2(46) and 113(3), the position under this Act was as follows:

Total world income comprised all income, profits and gains wherever accruing or arising, except (i) income which was excluded from the total income under ss 10 to 13 and (ii) any capital gains which were not includible in the assessee's total income. Generally speaking, a resident's total income would coincide with his total world income, for a resident would be taxable on his world income. A non-resident's total income comprised only income received in or accruing in India or deemed to be received in or to accrue in India, but the non-resident (other than a company) was charged on his total income at the average rate applicable to his total world income if he exercised the option granted to him by **s 113(3)** .

Since 1965, the concept of total world income has been altogether scrapped. Non-residents are assessable only at the rate applicable to their total income and in no case is their total world income relevant. (See further post under **s 5** , 'Scope' and 'Chargeability varies with factor of residence'.)

[47] ((47) "transfer", in relation to a capital asset, includes--

(*i*) the sale, exchange or relinquishment of the asset; or
(*ii*) the extinguishment of any rights therein; or
(*iii*) the compulsory acquisition thereof under any law; or

(*iv*) in a case where the asset is converted by the owner thereof into, or is treated by him as, stock-in-trade of a business carried on by him, such conversion or treatment;) [48] (or)

iva) [49] ((the maturity or redemption of a zero coupon bond; or)

(*v*) [48] (any transaction involving the allowing of the possession of any immovable property to be taken or retained in part performance of a contract of the nature referred to in **section 53A** [50] of the Transfer of Property Act, 1882 (4 of 1882); or

(*vi*) any transaction (whether by way of becoming a member of, or acquiring shares in, a co-operative society, company or other association of persons or by way of any agreement or any arrangement or in any other manner whatsoever) which has the effect of transferring, or enabling the enjoyment of, any immovable property.

Explanation [51] (*1*).--For the purposes of sub-clauses (*v*) and (*vi*), "immovable property" shall have the same meaning as in clause (*d*) of section 269UA.)

[52] (*Explanation 2* .--For the removal of doubts, it is hereby clarified that "transfer" includes and shall be deemed to have always included disposing of or parting with an asset or any interest therein, or creating any interest in any asset in any manner whatsoever, directly or indirectly, absolutely or conditionally, voluntarily or involuntarily, by way of an agreement (whether entered into in India or outside India) or otherwise, notwithstanding that such transfer of rights has been characterised as being effected or dependent upon or flowing from the transfer of a share or shares of a company registered or incorporated outside India;)

Clause (47) (Part of of 1922 Act): 'Transfer' in Relation to a Capital Asset. --Section 12B(1) of the 1922 Act levied tax on capital gains arising from the sale, exchange, relinquishment or transfer of a capital asset. **Section 45** of this Act levies tax on gains arising from the 'transfer' of a capital asset, and this clause originally defined 'transfer' as including 'the sale, exchange or relinquishment of the asset or the extinguishment of any rights therein or the compulsory acquisition thereof under any law'. The cases of extinguishment and acquisition were not mentioned in the provisions dealing with capital gains in the 1922 Act. The definition in this clause was further expanded with effect from April 1, 1985 and from April 1, 1988.

(i) Scope of the Definition. --This clause defines the word 'transfer' only in relation to a capital asset and has no bearing on the meaning of that word in any section where it is not used in relation to a capital asset. The expression 'capital asset' is used in the provisions dealing with the head of capital gains and, therefore, this definition is relevant for the purposes of that head only.

The definition of the word "transfer" as provided is an inclusive definition and does not exhaust other kinds of transfer [53] and does not exclude the contextual or the ordinary meaning of the word transfer. [54] The word "transfer" as defined in the old Act under **s 12B(1)** is similar to the one present in the new Act, it is comprehensive and is regarded generally as comprehending within its scope transfers both voluntary and involuntary. In the absence of a distinct genus or category, no presumption can arise that the word transfer must be construed in the sense of a voluntary transfer, because the words "sale", "exchange" and "relinquishment" are, in the normal acceptation of those terms, voluntary acts. The words "sale", "exchange", "relinquishment" and "transfer" must be given their plain and actual meanings and there is no justification for restricting the wide comprehension of the word "transfer" to voluntary transfers by the application of the *ejusdem generis* rule. [55] In order to constitute transfer, existence of the asset before and after the transfer is absolutely essential. [56] The implications of this definition are dealt with under ss 45 and 47 which deal with capital gains.

(ii) Sale. --The term sale has not been defined under this Act but the essential elements of a sale as per the Sale of Goods Act, 1930 are: (i) goods, (ii) seller and purchaser, (iii) agreement between them for sale and purchase (iv) transfer of property in the goods from seller to buyer as a result of the agreement between them and (v) the price being the consideration for the transfer of property. [57] The ordinary meaning of the word "sale" is a transaction entered into voluntarily between two persons known as the buyer and the seller by which the buyer acquires property of the seller for an agreed consideration known as the price. [58] Sale is a transfer of property in goods or of the ownership in immovable property for a money consideration. [59] Money consideration is an essential element of a sale. [60] The meaning of the word "sale" has changed significantly with the Constitution (Forty-sixth Amendment) Act, 1986 that inserted **Article 366(29A)** and made other changes in the Constitution. It is submitted that the concept of deemed sales will not apply to **s 2(47)** . The word "sale" will only mean sales as defined in the Sale of Goods Act, 1930 for movable property and as defined and understood under the Transfer of Property Act, 1882 for immovable property.

(iii) Exchange. --This word generally referred to the system of barter in the ancient days when money consideration was not prevalent. The Transfer of Property Act, 1882 provides that when two persons mutually transfer the ownership of one thing for the ownership of another, neither thing or both things being money only, such transaction is called an "exchange" . The transaction of an exchange involves the transfer of property by one person to another and reciprocally the transfer of property by that other to the first person. There must be a mutual transfer of ownership of one

thing for the ownership of another. [61] In other words, a transaction of exchange presupposes existence of different properties owned by different people; that as a result of such a transaction both the properties continued to exist; that as a result of such a transaction both the properties continued to be owned by two different parties but the ownership of one property is transferred to the owner of the other and *vice versa* . [62] But mere conversion of one currency into another currency cannot be considered as "exchange". The exchange in the context must mean transfer of one capital asset for another capital asset. [63] If the consideration is not money but some other valuable consideration, it may be an exchange or barter but not a sale. [64] It is to be noted that the word exchange is not limited to immovable property.

(iv) Relinquishment. --The meaning of the word "relinquish" as given in Webster's Comprehensive Dictionary, International edition, 1984, is "(1) to give up; abandon; surrender; (2) to cease to demand; renounce; to relinquish a claim; (3) to let go (a hold or something held). [65] Relinquishment implies that the person ceases to own the asset concerned by some act on his part. The property continues to exist, but the interest therein of the owner is either given up or abandoned. [66] In *Rasiklal* , [67] the Supreme Court held that relinquishment takes place when the owner withdraws himself from the property and abandons his rights thereto. The important element of relinquishment is that the property continues to exist after the relinquishment.

The assessee had paid an advance under an agreement for purchasing a property, reserving the right for specific performance, and later received consideration under another agreement in which the earlier agreement was cancelled and the vendor was permitted to sell the property to any person at any price. This resulted in relinquishment of the right by the assessee amounting to transfer. [68] Similar instances where relinquishment amounted to transfer have been discussed later under **s 45** .

(v) Extinguishment of Any Rights Therein. --The word "extinguishment" means extinction or annihilation of a right, estate, etc., by means of it being merged in, or consolidated with another, generally a greater or more extensive, right or estate. In other words, extinguishment will cover cases where a right, title or interest is destroyed, or taken away by an Act of God, operation of law, or an act of party.

The expression 'extinguishment of any rights therein' will have to be confined to the extinguishment of rights on account of transfer and cannot be extended to mean any extinguishment of rights independent of or otherwise than on account of transfer. The extinguishment of rights in the asset on account of extinguishment of the asset itself is not a transfer of the right but its destruction. By no stretch of imagination can the destruction of the right on account

of the destruction of the asset be equated with the extinguishment of the right on account of its transfer. [69] The expression does include the extinguishment of rights in a capital asset independent of and otherwise than on account of transfer. [70]

The rights of the assessee in the capital asset, being their shares in the amalgamating company, stood extinguished upon the amalgamation of the amalgamating company with the amalgamated company. There was, therefore, a transfer of shares in the amalgamating company within the meaning of **s 2(47)** . [71] However, in the case of amalgamation of a 100 per cent. subsidiary with its parent company, the entire capital and assets of the subsidiary company vest in the parent company as a result of the amalgamation and the parent company becomes the sole owner of the capital of the subsidiary company. There is, therefore, no extinguishment of the right of the parent company in the capital on the liquidation of the subsidiary company. [72] Reducing the face value of the share amounts to extinguishment of rights in shares, the share capital is reduced, the right of the shareholder to the dividend on his share capital and the right to share in the distribution of the net assets upon liquidation is extinguished proportionately to the extent of reduction in the capital. [73] Giving up a right to claim specific performance to get conveyance of immovable property in lieu of receiving consideration results in extinguishment of right in property. [74]

When a non-resident company transfers its shares to another non-resident company, there is no extinguishment of the rights of control and management that the transferor company has in its subsidiary or "downstream" companies. [75]

The primary argument on behalf of the Revenue was that the share purchase agreement (SPA) in the *Vodafone* case [76] showed that the transfer of shares outside India resulted in the extinguishment of the transferor's right of control and management. Several clauses of the SPA were referred to but this plea was rejected. The court held that it was concerned with the sale of shares and not the sale of assets. It was necessary to apply the *"look at"* test and not the *"look through"* test. The vacillating stand by the department was on account of a *dissected approach.* After analyzing the entire shareholding structure, which included several Mauritian companies and the ultimate holding company in Cayman Island, it was held that the Hong Kong parent company had only a *persuasive position* over the downstream companies *qua* the manner of voting, nomination of directors and management rights. The minority shareholders and investors had participative and protective rights. Consequently, there was no extinguishment of right so as to attract capital gains.

It is also submitted that rights of management and control are incidental, and often proportional, to the number of shares owned

by the transferor. When he sells his shares, the transferee gets these rights as a consequence of buying the asset (which is a share). It will be incorrect to state that the rights of management and control are "extinguished". Indeed, they never do; then only go to the transferee in the same manner as the right to receive dividend goes to him/her.

(vi) Clauses (v) and (vi). --The purpose of introducing sub-cl (v) in conjunction with sub-cl (vi) in **s 2(47)** defining the term 'transfer' was to widen the net of taxation of capital gains and include transactions that closely resembled transfers but were not treated as such under the general law. Avoidance or postponement of tax or capital gains by adopting devices such as the enjoyment of property in pursuance of a revocable power of attorney or part performance of a contract of sale was sought to be arrested by introducing the two clauses, cls (v) and (vi), in **s 2(47)** . **Section 2(47)** contemplates a transaction which enables direct and immediate possession to be taken and not one where the possession is allowed to be taken at a later date or on the happening of an event. Possession need not be exclusive; it is sufficient if the transferee has the right to enter upon and exercise even limited possessory rights. [77]

A transaction is covered by cl (iv) when the full consideration is received and possession handed over under a "power of attorney". The subsequent action of a power of attorney and execution of sale deed by the power of attorney holder will not alter the applicability of **s 53A** . [78]

The conversion of a firm into a company under Part IX of the **Companies Act** , 1956 does not amount to a transfer. [79] The assets of a firm belong to and are owned by the partners of the firm. So long as the partnership continues, each partner is interested in all the assets of the firm as each partner is owner of the assets to the extent of his share in the partnership. On dissolution, assets which heretofore belonged to the partners stand allotted to the partners individually and there is no transfer or assignment of ownership in the assets. Consequently, **s 17** of the Indian Registration Act, 1908 does not apply. Although **s 2(47)** has been not specifically amended, **s 45(4)** would warrant a presumption that, on dissolution, there is a transfer within **s 2(47)** . [80]

(vii) Transfer of Assets--Not of Underlying Assets. --On the transfer of shares situated overseas, the entire rights stood transferred, not in India, but off-shore. On the transfer of such shares, the transferee gets all those rights which include the right to receive dividends, right to transmit, right to vote and all those shares including controlling interest is part of integral price for the share. [81]

In the context of **s 9(1)(i)** , it was held that the transfer of a

share will not result in transfer of any "underlying asset". The latter expression does not find a place in **s 9** . The same principle will apply to **s 2(14)** . When a capital asset is transferred, it is not open to the department to dissect the transaction and any tax on the underlying asset or underlying interest in the asset. It should be noted that there is transfer of an asset and there are certain consequences that arise on the transfer of an asset. For example, the transfer of a building which has several tenants will entitle the transferee to collect the rents after the transfer is complete but there is only transfer of the building and there is no question of taxing the transfer of leasehold interest separately. [82]

(viii) Explanation 2. --Explanation 2 has been inserted with retrospective effect from April 1, 1962. This is one more amendment to set at naught the decision in the *Vodafone* case. [83] The Supreme Court held that the transfer of shares did not result in the transfer of any underlying assets. The latter part of **s 9** did not cover any indirect transfer and that there was no *"look through"* provision. A dissecting approach was not permissible. [84] Explanation *2* now makes it clear that definition of "transfer" will include a dissecting approach and if an asset is transferred, it automatically means that there is disposition or parting of interest therein. Rights, which do not have separate existence, but flow along with the transfer of a share are also included within the word "transfer". Thus, what cannot be transferred is also now included in the word "transfer". By using the words *directly or indirectly* ; *absolutely or conditionally* ; *voluntarily or involuntarily* , the meaning of the word "transfer" has been given the widest possible scope. Further, by adding the words "whether entered into in India or outside India", even overseas transfers of an asset can result in a transfer of an interest in India. Thus, even extra territorial transactions are not spared. It is submitted that this amendment is draconian and also unconstitutional. No other country has such a draconian provision which seeks to tax virtually every transaction which has an Indian connection, howsoever remote it may be.

Alienation under DTAA is not a transfer under this clause. [85]

Mercifully, the Board has issued letter No.F.No.500/111/12009-FTD-1(Pt.) dated May 29, 2012 clarifying that assessments which have been completed under **s 143(3)** and before April 1, 2012 will not be reopened under **s 147** .

[86] ((48) "zero coupon bond" means a bond--

(*a*) issued by any infrastructure capital company or infrastructure capital fund or public sector company [87] (or scheduled bank) on or after the 1st day of June, 2005;

(*b*) in respect of which no payment and benefit is received or receivable before maturity or redemption from infrastructure capital

company or infrastructure capital fund or public sector company [87] (or scheduled bank); and

(*c*) which the Central Government may, by notification in the Official Gazette, specify in this behalf.

[88] (* * * * *)).

[89] (*Explanation.* --For the purposes of this clause, the expression "scheduled bank" shall have the meaning assigned to it in clause (*ii*) of the *Explanation* to sub-clause (*c*) of clause (*viia*) of sub- section (1) of section 36.)

Clause (48)(now deleted) (of 1922 Act): Unregistered Firm. --This definition was the same as in the 1922 Act. Two types of firms were regarded as unregistered firms: (i) a firm which was assessed as an unregistered firm, and (ii) a firm which was not assessed at all, though its partners may have been assessed individually on their respective shares in the firm's profits. This definition is deleted because of the introduction of the new procedure for taxation of firms.

The omitted clause has been replaced with definition for 'zero coupon bond' by **Finance Act** , 2005.

S. 3.

"Previous year" defined

[90] (For the purposes of this Act, "previous year" means the financial year immediately preceding the assessment year:

Provided that, in the case of a business or profession newly set up, or a source of income newly coming into existence, in the said financial year, the previous year shall be the period beginning with the date of setting up of the business or profession, or as the case may be, the date on which the source of income newly comes into existence and ending with the said financial year.)

Pre-1989 Law

1. (of 1922 Act): Previous Year. --The original definition which was in operation till the assessment year 1988-89 was more elaborate and logical than the corresponding definition in the 1922 Act. It was changed by the Direct Tax Laws (Amendment) Act, 1987.

The tax is levied for each financial year commencing on April 1, at the rate or rates prescribed in the Finance Act for the year and is actually charged on the 'total income of the previous year'. [1] Income-tax liability crystallises on the last day of the previous year. [2] The year for which the tax is paid is called the 'assessment [3] or 'income-tax year'. The 'previous year' on the income of which the tax is levied is also called the 'accounting year'.

(a) Old Sub-section (1), Clauses (a) and (b): 'Previous Year' must end with or within the Preceding Financial Year. --The 'previous year', as defined by this sub-section, is generally the financial year immediately preceding the assessment year. [4] However, an assessee may have made up his accounts on the basis of the Hindu, Christian or other calendar year, or he may have made up his accounts on the basis of a twelve-month period starting from any odd day of the year. In that event the option is given to the assessee to have as his 'previous year' either the immediately preceding financial year or the period ending within such year for which he has made up his accounts. [5] But the option must be exercised clearly by making a statement or by other conduct which expresses or implies the exercise of the option; mere production of accounts for a period other than the financial year would not be tantamount to exercise of the option. [6]

(b) Old Sub-section (1), Clauses (d) and (e), and Sub-section (2): Newly Set up Business. --Where a business, profession or vocation has been newly set up in the financial year preceding the assessment year, the previous year would be:

(a) the period from the date of the setting up of the business, profession or vocation to the March 31, next following; [7] or

(b) the period from the date of the setting up of the business, profession or vocation to the last day of the period determined by the [8] under sub-s (1)(c); or

(c) if the accounts of the assessee are made up, in respect of a period not exceeding twelve [9] from the date of the setting up of the business, profession or vocation, to some date other than March 31, and the case is not one for which a period has been determined by the department under sub-s (1)(c), then at the option of the assessee, the period from the date of the setting up of the business, profession or vocation to such other date.

Thus, if a business is set up on June 1, 1982 and the accounts are made up to May 31, 1983, the assessee may elect to have the year ended May 31, 1983 as his 'previous year', and in that case there will be deemed to be no previous year for the assessment year 1983-84, the profits for the year ended May 31, 1983 being taken as the profits of the 'previous year' for the assessment year 1984-85. [10] If, however, an assessee sets up a business on June 1, 1982 and makes up his accounts up to December 31, 1982, and elects to have the year ended December 31, taken as his 'previous year', the period from June 1, to December 31, 1982 would be taken as the previous year for the assessment year l983-84. If the assessee has made up his accounts for a period exceeding twelve months, he cannot claim the benefit of the option of choosing his own accounting period as his previous year. [11]

Where a business changes hands, the seller and the buyer should each be assessed in respect of his actual share, if any, of the profits of the previous year. [12] If a new firm carries on the business of a dissolved firm, it is entitled to adopt a previous year different from the one adopted by the dissolved firm. [13] A joint venture

assessed as an AOP, was taken over by the assessee trust as its proprietary undertaking during the year and assessed as such in its hands. The same income could not be subject to assessment in the hands of erstwhile venture. [14]

Setting up and Commencement of Business. --The language of this sub-clause makes it clear that in the case of a new business the first accounting year must in every case commence on the date of the setting up of the business. A business is set up when it is established or set on foot. There may be an interregnum between the setting up of a business and its actual commencement; [15] and the accounting year would begin on the date the business is set up and not when it is actually commenced. [16]

(c) Old Sub-section (1), Clause (f): Previous Year of Partner. --This clause lays down that in respect of a partner's share of the profits of the firm, the previous year must necessarily be taken to be the previous year as determined for the assessment of the firm in a case where the firm has been assessed as such, [17] although he can have a different previous year for his other income. [18] In a case where the firm has not been assessed as such, *i.e.* where an assessment is made directly on a partner in respect of his share of the firm's profits without any assessment being at all made on the firm, [19] the previous year of the partner would be governed by the provisions of cll (a), (b) and (c).

Share of Profit, Previous Year ( ). --Where the assessee is a partner in a firm and the firm has been assessed as such, the period determined as the previous year for the firm has also to be treated as the previous year for the assessee in respect of his share in the income of the firm. [20] Even in the former case, the assessee partner, in respect of his personal income, may have a different previous year from that of the firm, since this clause has no application to such income.

(d) Old Sub-section (3): Different Previous Years. --An assessee is entitled to have different previous years in respect of his income under different [21] and also in respect of separate sources of his income even under the same head. [22] For instance, an assessee may have as his 'previous year' the financial year for one business and the Tamil year for another business. [23] 'Source' means not a legal concept but something which a practical man would regard as a real source of income. [24]

Each branch of a business is a separate source. [25] An assessee having a head office and branch offices may have two 'previous years', one for the head office and one for the branches, but in his assessment he must add the results of the two, each year and make his return on this basis. He cannot accumulate the results of two years of the branches and account for them in one year's results of the head office. [26] The principle is that where an assessee has different previous years in respect of separate sources of income, the income of the varying previous years from the different sources should be lumped together to arrive at the total income. The provisions of this section make it clear that except in cases where a previous year is determined by the Board or other authority under sub-s (1)(c), the varying previous years must all necessarily end with or within the financial year next preceding the assessment year. [27]

(e) Old Sub-section (4): Change of Previous Year. --This sub-section enacts that where in respect of a particular source of income or in respect of a business, profession or [28] newly set up, (i) once an assessee has been [29] or (ii) he has once exercised the option under cl (b) or other appropriate clause although no assessment may have yet been made or could have been made as a result of the exercise of the option, [30] the assessee cannot in respect of that source, business, profession or vocation change his previous year except with the consent of the AO and upon such conditions as the AO may impose. [31] The change of the previous year should be a conscious deliberate act on the part of the assessee. [32] The consent of the AO may be express or implied by his conduct, [33] and may be obtained after the filing of the return. [34] The AO can only impose conditions which are reasonable and consonant with the Act. [35] For example, he may make it a condition that the first previous year after the change will comprise of more than twelve months; [36] but he has no power to vary the rate of tax at which the income is to be assessed, [37] or to curtail statutory deductions. [38] If the assessee undertakes to make

good the loss of revenue on account of the change, the AO should give his consent to the change. [39]

The AO's discretion must be exercised judicially and in conformity with the legislative intent which is to give consent save in exceptional cases. [40] The AO should give a hearing to the assessee before deciding to refuse consent or to grant it on conditions, [41] and he should give reasons in support of his order. [42] The consent granted by the AO cannot be revoked by his successor while making the assessment. [43]

(f) Previous Year for Unexplained Investments, Expenditure and Cash Credits, and for Borrowals on Hundies Deemed to be Income. --(See post ss 68 to 69D.)

(g) Appeal, Revision and Reference. --An appeal lies under **s 246(1)(c)** against the AO's refusal to give consent to change of the previous year. [44] The decision of the AO under **s 3(4)** consenting or refusing to consent to change of the previous year is an 'order' which the Commissioner can revise. [45]

In the context of **s 3** , the undernoted cases held that referable question of law did not arise [46] under **s 256** .

(h) Writ, Direction or Order. --A writ, direction or order may be issued in appropriate cases. [47] (For the principles underlying the grant of such relief, see under **s 293** , 'Writs, directions and orders under Constitution'.)

2. Law from Assessment Year 1989-90. --The Direct Tax Laws (Amendment) Act, 1987 has completely altered the definition of 'previous year' with effect from the assessment year 1989-90. The options (a) of choosing any accounting year as the 'previous year' and (b) of having different previous years for different sources of income are no longer available to the assessee; and the financial year is uniformly prescribed as the previous year for all assessees.

While the amended definition of 'previous year' applies for the purposes of assessment under this Act, the assessee is entitled to make his own accounts up to any date. In other words, he has the same freedom as he had in the past to choose any accounting year for the purposes of his own books of account; and he has likewise the freedom to choose different previous years for different sources of income. Needless to add, the exercise of this freedom would entail endless litigation with the revenue regarding the correct computation of business income for the fiscal previous year which would vary from the assessee's own accounting year.

Where a business, profession or vocation is newly set up, or a source of income newly comes into existence, in the financial year preceding the assessment year, the 'previous year' would be the period from the date when the business, profession or vocation is set up or the source of income comes into existence to the March, 31, next following.

Sub-sections (2) and (3) of the new section and Sch X, read with **r 125** , make special provisions for the transitional period, *i.e.* for the previous year-relevant to the assessment year 1989-90. [48] These transitory provisions were deleted by the Finance Act, 1999, since they were no longer applicable.

3. Period When to be Dealt with as Transitional Period. --The assessee was following an accounting year other than April, 1 to March, 31. Following, in view of the provisions contained in **s 3** as amended by the 1987 amendment effective from 1-4-1988, the fraction of the period from 1-7-1987 till 31-3-1988 was included in the return for the period ending 31-3-1989. By reason of the substitution of the definition of 'previous year' through the 1987 amendment effective from 1-4-1988, the period following was to be dealt with the as the transitional period as contemplated under **s 3(2)** read with the Tenth Schedule. [49]

90 Subs. by the Finance Act, 1999 (27 of 1999), **s 4** (w.e.f. 1-4-2000), Circular No. 779, September 14, 1999, 240 ITR (St.) 3, for the following:-- ' ***a*** [**"Previous year" defined** -- (1) Save as otherwise provided in this section, "previous year" for the purposes of this Act, means the financial year immediately preceding the assessment year: *Provided* that, in the case of a business or profession newly set up, or a source of income newly coming into existence, in the said financial year, the previous year shall be the period beginning with the date of setting up of the business or profession or, as the case may be, the date on which the source of income newly comes into existence and ending with the said financial year. (2) "Previous year", in relation to the assessment year commencing on the 1st day of April, 1989, means the period which begins with the date immediately following the last day of the previous year relevant to the assessment year commencing on the 1st day of April, 1988, and ends on the 31st day of March, 1989: *Provided* that where the assessee has adopted more than one period as the "previous year" in rela-tion to the assessment year commencing on the 1st day of April, 1988, for different sources of his in-come, the previous year in relation to the assessment year commencing on the 1st day of April, 1989, shall be reckoned separately in the manner aforesaid in respect of each such source of income, and the longer or the longest of the periods so reckoned shall be the previous year for the said assessment year: ***b*** [*Provided further* that in the case of a business or profession newly set up, or a source of income newly coming into existence on or after the 1st day of April, 1987, but before the 1st day of April, 1988, and where the accounts in relation to such business or profession or source of income have not been made up to the 31st day of March, 1988, the "previous year" in relation to the assessment year commencing on the 1st day of April, 1989, shall be the period beginning with the date of setting up of the business or profession or, as the case may be, the date on which the source of income newly comes into existence and ending on the 31st day of March, 1989: *Provided also* that where the assessee has adopted one or more periods as the "previous year" in relation to the assessment year commencing on the 1st day of April, 1988, for any source or sources of his income, in addition to the business or profession or source of income referred to in the second proviso, the previous year in relation to the assessment year commencing on the 1st day of April, 1989, shall be reckoned separately in the manner aforesaid in respect of each such source of income, and the longer or the longest of the periods so reckoned shall be the previous year in relation to the said assessment year.] (3) Where the previous year in relation to the assessment year commencing on the 1st day of April, 1989, referred to in sub-section (2) exceeds a period of twelve months, the provisions of this Act shall apply subject to the modifications specified in the rules in the Tenth Schedule.]'. Subs. by the Direct Tax Laws (Amendment) Act, 1987 (4 of 1988), **s 4** (w.e.f. 1-4-1989), for **section 3** . The second and the third provisos have been inserted by the Direct Tax Laws (Amendment) Act, 1989 (3 of 1989), **s 3** (w.e.f. 1-4-1989).

1 **Section 4(1)** .

2 *Pradeep Trust v CIT* 325 ITR 1 , (2010) 3 Cal LT 46 , (2010) 234 CTR 187 (Cal).

3 **Section 2(9)** .

4 *Chunilal v CIT* 66 ITR 522, 544 -45; *CIT v Vishnudayal* 123 ITR 140 ; *CIT v Kothari* 160 ITR 27 ; *CIT v India Sea Foods* 168 ITR 721 ; *CIT v Lohada* 174 ITR 318 ; *Malik v CIT* 124 ITR 522 .

5 *Bhailal v CIT* 68 ITR 136 , *CIT v Patiala Sales* 77 ITR 443 and *CIT v John Peter* 243 ITR 561 ('making up accounts' explained); *CIT v Vijaya* 116 ITR 53 ('round about Diwali day'); *CIT v Harichand* 154 ITR 202 (income from the property); *CIT v Nellai* 154 ITR 355 and *CIT v Renu* 160 ITR 855 (capital gains); *Fort Properties v CIT* 208 ITR 232 ; *CIT v Rashmi* 217 ITR 559 ; *CIT v Amarlal* 239 ITR 495 .

6 *Binodiram v CIT* 44 ITR 249 , affirmed in *CIT v Binodiram* 77 ITR 128 (SC); *Bisheshwar v CIT* 27 ITR 376 ; *Malik v CIT* 124 ITR 522 ; *CIT v Nellai* 154 ITR 355 ; *CST v Brihan Sugar* 165 ITR 217 ; *CIT v Obulisami* 115 ITR 794 (option exercised before the tribunal).

7 *Kisan Ghar v CIT* 188 ITR 810 . Cf *CIT v Ravinder Kumar* 180 ITR 203 (no new business set up).

8 *Nanakchand v CIT* 2 ITC 167 .

9 *Madras Machine Tools v CIT* 98 ITR 119 .

10 *Chandulal v CIT* 44 ITR 448 ; *CIT v Nuthern P. Ltd.* 284 ITR 396 , (2006) 200 CTR 649 (Guj); *CIT v Punjab Gas Cylinder Ltd.* 328 ITR 162 , (2010) 190 Taxman 415 (P&H); *CIT v Nirmal Kumar Soorana* 263 ITR 322 , (2003) 185 CTR 552 (Raj); *CIT v Vimal Kumar Soorana* 269 ITR 288 , (2004) 188 CTR 589 (Raj).

11 *Re General Comm Corpn* 26 ITR 316 ; *Kisan Ghar v CIT* 188 ITR 810 .

12 See ss 170 and 188.

13 *CIT v Ghasita Mal* 226 ITR 239 .

14 *Pradeep Trust v CIT* 325 ITR 1 , (2010) 3 Cal LT 46 , (2010) 234 CTR 187 (Cal).

15 See post under **s 29** , 'No allowances in respect of business not yet set up at date of expenditure'.

16 *CIT v IG Electronic (India) Ltd.* 282 ITR 545 , (2005) 199 CTR 205 (Del).

17 *CIT v Rowhter* 46 ITR 259 ; *CIT v Mckenzies* 121 ITR 458 ; *Biswanath v CIT* 189 ITR 687 ; *Nirmal v CIT* 201 ITR 692 ; *New Ambadi v CIT* 228 ITR 141 ; *CIT v Greenham* 254 ITR 402 ; *CIT v Greenham Estates P. Ltd.* 285 ITR 345 , (2006) 203 CTR 240 (Mad).

18 *CIT v Greenham* 254 ITR 402 ; *CIT v Greenhan Estates P. Ltd* 285 ITR 345 .

19 See post under under ss 182-83, 'Direct assessment on partner without assessment on firm'.

20 *CIT v Bhanumati & Sons Trust* 268 ITR 193 .

21 *CIT v India Sea Foods* 168 ITR 721 .

22 *Girdharlal v CIT* 53 ITR 23 ; *Sobhagmal v CIT* 63 ITR 424 ; *JK Synthetics v Bajpai* 105 ITR 864 , on appeal *UOI v JK Synthetics* 199 ITR 14 (SC); *CIT v Ramachandra* 127 ITR 414 (salary); *Fort Properties v CIT* 208 ITR 232 ; *CIT v Murali* 216 ITR 166 ; *CIT v Ramesh* 249 ITR 359 ; *CIT v Estate Mineral* 253 ITR 757 .

23 *CIT v Savumiamurthy* 14 ITR 185 .

24 See post under **s 5** , 'From whatever source derived'.

25 *CIT v Kanchanbai* 44 ITR 242 , affirmed 77 ITR 123 (SC).

26 *Melamal v CIT* 5 ITR 329 .

27 This commentary was explained in *Appaiya v State of Karnataka* 188 ITR 793, 799 -80.

28 See 2(36).

29 *CIT v Kanchambai* 77 ITR 123 (SC) and *CIT v Binodiram* 77 ITR 128 (SC) foreign income of

non-resident, not included in total income but taken into account only for rate purposes, is not 'assessed'.

30 See *Re General Comm Corpn* 26 ITR 316, 323.

31 *Ormerods v CIT* 49 ITR 485 ; *Ramjidas v CIT* 66 ITR 260 ; *Dalmia v ITO* 88 ITR 21 (fair exercise of descretion). Cf *Gauri v CIT* 120 ITR 338 (no change involved).

32 *CIT v Swamy* 195 ITR 707 .

33 *Karnal Society v CIT* 84 ITR 46 ; *Rattanlal v CIT* 144 ITR 135 .

34 *CIT v Mumtaz* 101 ITR 355 .

35 *JK Synthetics v Bajpai* 105 ITR 864 , on appeal, *UOI v JK Synthetics* 199 ITR 14 (SC); *VXL v ITO* 168 ITR 805 ; *CIT v Swamy* 195 ITR 707 ; *Gujarat Carbon v DCIT* 216 ITR 415 ; *CIT v Hariprosad* 143 ITR 276, 280 . A condition to prevent loss of revenue may be one of them: *Assam Tea v IAC* 164 ITR 253 ; *Dalmia v ITO* 88 ITR 21 ; *Midas Rubber v CIT* 232 ITR 824 ; *CIT v Electric Control Gear* 266 ITR 338 , (2003) 183 CTR 540 (Guj).

36 *Esthuri v CIT* 60 ITR 411 (SC); *Ardeshir v CIT* 59 ITR 57 ; *Jamuna v CIT* 159 ITR 986 ; *Assam Tea v IAC* 164 ITR 253 .

37 *Esthuri v CIT* 60 ITR 411 (SC); *Pilliah v CIT* 75 ITR 129 .

38 *CIT v Premier* 239 ITR 165 ; *CIT v DPF Textiles* 241 ITR 548 .

39 *Empire v UOI* 255 ITR 140 .

40 *Assam Tea v IAC* 164 ITR 253 ; *Vazirbun v CIT* 251 ITR 573 (belated application rejected).

41 *Bennett Coleman v Allahiri* 141 ITR 239 ; Cf *Assam Tea v IAC* 164 ITR 253 .

42 See p 40, n 12.

43 *CIT v Hariprosad* 143 ITR 276 ; *JK Synthetics v Bajpai* 105 ITR 864 , on appeal, *UOI v JK Synthetics* 199 ITR 14 (SC).

44 *CIT v Hariprosad* 143 ITR 276 ; *CIT v Arun Kumar* 229 ITR 175 ; contrary decision in *Delhi Stockholders Assn v CIT* 59 ITR 16 is incorrect.

45 *Bennett Coleman v Allahiri* 141 ITR 239 .

46 *EID Parry (India) Ltd v CIT* 243 ITR 116 ; *Kisan Ghar v CIT* 188 ITR 810 .

47 See cases cited above under 'change of previous year'.

48 *CIT v Mahavir* 228 ITR 407 (depreciation for 23 months).

49 *Kalyanpur Cement Ltd. v JCIT* 276 ITR 49 , (2005) 195 CTR 39 (Cal).

THE INCOME-TAX ACT, 1961 (ACT NO. XLIII OF 1961)

CHAPTER II

Basis of Charge

S. 4.

Charge of income-tax

(1) Where any Central Act enacts that income-tax shall be charged for any assessment year at any rate or rates, income-tax at that rate or those rates shall be charged for that year in accordance with, and [1] (subject to the provisions (including provisions for the levy of additional income-tax) of, this Act) in respect of the total income of the previous year [2] (* * * *) of every person:

Provided that where by virtue of any provision of this Act, income-tax is to be charged in respect of the income of a period other than the previous year, income-tax shall be charged accordingly.

(2) In respect of income chargeable under sub-section (1), income-tax shall be deducted at the source or paid in advance, where it is so deductible or payable under any provision of *this* Act.

1. (and of 1922 Act): The Charging Section. --The provisions of sub-s (1) are the same as those of **s 3** of the 1922 Act except for two changes:

(i) the present sub-s (1) originally referred to 'the previous year or previous years', thus recognising the possibility of an assessee having more previous years than one; whereas the old section referred only to 'the previous year' (the reference to 'previous years' was deleted with effect from April 1, 1989 when the assessee was deprived of his right of having more previous years than one);

(ii) the old section enumerated the categories of assessees, while this sub-section taxes every 'person', and the definition of 'person' in **s 2(31)** enumerates the categories of assessees including two which were not in the 1922 Act, *viz.*, 'body of individuals' and 'artificial juridical person'.

The proviso to sub-s (1), and sub-s (2), are reproductions of sub-ss (1) and (2) respectively of **s 60B** which was inserted in 1960 in the 1922 Act with retrospective effect from the commencement of that Act. The 'additional income-tax' mentioned in sub-s (1) is that leviable under **s 143(1A)** with effect from April 1, 1989.

The section imposes income-tax upon a person in respect of his income. [3] As Beaumont CJ said in *Re Patiala State Bank,* [4] 'Income-tax is a tax on a person in relation to his income .the tax is not made a charge on the income upon which it is levied.' Charge is attracted at the point when the income is earned and the taxability does not depend upon the destination or manner of utilisation of income. [5] Income returned under an erroneous understanding or misconception of law is not chargeable under the Act. [6] The Act imposes a liability to tax upon income. It does not provide that whatever is received by a person can be regarded as his income liable to tax. Further, if an income falling under a specific head of income is not taxable under that head for some reasons, such income cannot be charged to tax under any other head of income. [7]

The scheme of the charging provisions of this Act is the same as that of the corresponding provisions of the 1922 Act. In *Wallace Bros & Co. Ltd. v CIT* , [8] the Privy Council referred to **s 3** of the 1922 Act (**s 4** of this Act) alone as the charging section, [9] while the Federal Court observed in *Chatturam v CIT,* [10] that ss 3 and 4 of the 1922 Act (ss 4 and 5 of this Act) were the charging sections. [11] In *Probhat Chandra Barua v CIT,* [12] the Privy Council observed that **s 6** of the 1922 Act (**s 14** of this Act) was the real charging section; however, that case arose before the amendment of the 1922 Act in 1939, and the observation did not hold good after the amendment of the 1922 Act in 1939 [13] nor would it apply under the present Act.

2. Total Income--Subject to Provisions of This Act . --This expression has been used in ss 4 and 5 and, consequently, the other provisions of the Act can have an overriding effect over these provisions. Thus, for example, the provisions of ss 10 - 13A and **s 90** would have the effect of exempting income which would otherwise be chargeable under this section. Similarly, a notification issued under **s 90** to implement the terms of a Double Taxation Avoidance Agreement would automatically override the provisions of the Act in the matter of chargeability (**s 4**) and ascertainment of total income (**s 5**). [14]

3. Liability to Tax does not Depend on Assessment. --Commenting on the scheme of the charging section, the Privy Council said in *Wallace Bros & Co. Ltd. v CIT,* [15] 'the rate of tax for the year of assessment may be fixed after the close of the previous year and the assessment will necessarily be made after the close of that year. However, the liability to tax arises by virtue of the charging section alone, and it arises not later than the close of the previous year, though quantification of the amount payable is postponed'. [16] The same principle was enunciated by the Supreme Court in *Kesoram Industries & Cotton Mills Ltd. v CWT* , [17] and *Setu Parvati Bayi v CWT.* [18] The Federal Court laid down in *Chatturam v CIT,* [19] relying upon the decision of the House of Lords in *Whitney v IR,* [20] that liability to tax does not depend on assessment; that *ex hypothesi* has already been fixed: the assessment order only quantifies the liability which is already definitely and finally created by the charging sections. [21] The Supreme Court [22] has reiterated these principles and has held that the liability to pay income-tax arises as soon as the relevant Finance Act prescribes the rate of tax for the relevant assessment year.

4. Basic Principles. --The following principles emerge from an analysis of this section:

(i) income-tax is to be charged at the rate or rates fixed for the year by the annual Finance Act;
(ii) the charge is on every person, including the assessable entities enumerated in **s 2(31)** ;
(iii) the income taxed is that of the previous year and not of the year of assessment; and
(iv) the levy is to be on the total income of the assessable entity computed in accordance with and

subject to the provisions of this Act.

(a) Rates of Tax Fixed by Annual Finance Act.--The purpose of this section is to charge income-tax at the current rate for the time being. [23] Income-tax includes surcharge. [24] The rate of tax must be related to the total income of the previous year. The provisions of the Finance Acts of 1955 and earlier years under which additional tax was levied in respect of 'excess dividends' did not operate to impose a valid charge, since such additional tax was unrelated to the total income. [25] The provisions in the various Finance Acts prescribing graduated scales for payment of tax, *i.e.* different rates for different slabs of income, are not *ultra vires* **Art. 14** of the **Constitution** ; [26] and similarly, those prescribing different rates of tax for different categories of HUFs are not *ultra vires* **Art. 14** , **15** or **19(1)** of the **Constitution** . [27] This Act is a permanent enactment, but as the Privy Council observed in *Maharajah of Pithapuram v CIT,* [28] that this Act 'has no operative effect except so far as it is rendered applicable for the recovery of tax imposed for a particular fiscal year by a Finance Act'. However, **s 294** provides that if on April 1, in any year, the new Finance Bill has not yet been placed on the statute book, the provision in force in the preceding year or the provision proposed in the Bill then before the Parliament, whichever is more favourable to the assessee, shall apply until the new provision becomes effective.

The income-tax is of course an annual tax, not only in the sense that it is annually imposed by the Finance Act, but in the sense that it is annual in its structure and organisation. 'It was necessarily so whenit was thought to be intended as a temporary tax, and it has nonetheless remained so although it has become a permanent tax--annual in the sense that you have it every year, like the seasons'. [29] The Finance Acts, though annual, are not temporary Acts; they often contain provisions of a general character which are of permanent operation, [30] and further, they may withdraw or reduce an exemption granted by this Act. [31] For the last several years the Indian Finance Acts have been used as the main instrument for amending (often mutilating) this Act.

(b) Units of Assessment.--The charge is on every 'person', which under **s 2(31)** includes (i) an individual, (ii) a Hindu undivided family, (iii) a company, (iv) a firm, (v) an association of persons or a body of individuals, whether incorporated or not, (vi) a local authority, and (vii) every artificial juridical person not falling within any of the preceding clauses. (See under ss 2(17), 2(23) and 2(31).) A company, in the eyes of law, comes into existence only upon its incorporation, and hence, it is not chargeable in respect of pre-incorporation profits. [32] Further, a constituent unit or a branch of an assessable entity is not a separate unit of assessment and therefore, not separately assessable to tax. [33]

Under the charging section, assessment is to be made on the right person alone. By 'right person' is meant the person who is liable to be taxed, according to law, with respect to a particular income, [34] and if a wrong person is taxed with respect to a particular income, the assessing officer is not precluded from taxing the right person with respect to that income. [35] The same income assessed in the hands of the beneficiaries cannot be taxed in the hands of the trustee. [36]

(c) Tax is on Income of Previous Year.--Under this section the subject of charge is the income of the previous year and not the income of the assessment year. [37] In other words, the tax 'is assessed and paid in the next succeeding year upon the results of the year before'. [38] This is in direct contrast to the British income-tax law under which the subject of assessment is the income of the year of assessment, though the amount is measured by a yardstick based on the income of preceding years. [39] The proviso to sub-s (1) refers to exceptional cases--like those of a discontinued business (**s 176(1)**), persons about to leave India (**s 174**) or likely to transfer property to avoid tax (**s 175**), and occasional shipping (**s 172**), in which the income of the assessment year may be taxed in that very year.

Though the tax is charged for an assessment year in respect of the income of the previous year, as a result of the processes of accelerated recovery in the forms of deduction at source and advance payment of tax (**s 190**), tax is actually paid on most incomes before the commencement of the assessment year. Sub-section (2)

provides a warrant for this procedure in the charging section.

Since under this Act, the tax is levied on the actual income of the previous year, the facts must be taken as they existed during the previous year. For instance, if a certain area was part of India during the relevant previous year, losses incurred or profits accrued in that area must be deemed to have been incurred or to have accrued in India, although that area might have ceased to be part of India in the assessment year or later. [40] Conversely, since the Act is extended to the Continental Shelf and the Exclusive Economic Zone of India by notification dated March 31, 1983 with effect from April 1, 1983, it would not apply to any income which accrued in these areas prior to April 1, 1983. [41] Similarly, since the Act is extended to the State of Sikkim from assessment year 1990-91, [42] it would not apply to income of the prior period. [43]

(See **s 3** for the definition of 'Previous year'.)

Source of Income Need not be Extant in Assessment Year. --Under the British law, the subject of charge being the income of the assessment year, the continued existence of the source of income in the assessment year is a requisite of chargeability. [44] However, under this Act, the income of the previous year is itself the subject-matter of the tax; therefore, it is immaterial whether the source of income is extant or defunct in the assessment year. [45] (See further under **s 28(i)** , 'Business should have been carried on in accounting year'.)

(d) Each year is Separate, Self-contained Period.--As noted above, the income-tax is annual in its structure and organisation. [46] Each 'previous year' is a distinct unit of time for the purposes of assessment and the profits made, or the liabilities or losses incurred before or after the relevant previous year are immaterial in assessing the profits of that year, [47] unless there is a statutory provision to the contrary, *e.g.* in **s 72** which allows business losses to be carried forward. Delivering the judgement of the Privy Council in *CIT v Chitnavis,* [48] Lord Russell observed, 'What are chargeable to income-tax are the profits and gains of a yearFor the purpose of computing yearly profits and gains, each year is a separate self-contained period of time, in regard to which profits earned or losses sustained before its commencement are irrelevant'. The mere fact that certain income has not suffered tax in the relevant assessment year because of a device adopted by the assessee or otherwise, would not enable the department to assess the same as the income of a subsequent year when the mistake becomes apparent. [49] It is only where, according to a particular system of accounting adopted by the assessee himself, allocations are made not in the year when the amount accrues or is received, but in later years, that the income so allocated would be liable to be charged as income of the later years. [50] *In dubio* what the assessee himself chooses to treat as income may well be taken to be income and to arise when he so chooses to treat it. [51]

In the case of a single business venture spread over years, it depends on the facts of each case whether the profits should be computed and assessed when the entire venture comes to an end or the cost is recouped, or whether the profits should be regarded as accruing from year to year and assessed accordingly. (See under **s 5(1)(b)** , 'Single transaction', and under **s 145(1)** , 'Computation of business profits'.)

Law to be Applied is that in Force in Assessment Year. --Though the subject of the charge is the income of the previous year, the law to be applied is that in force in the assessment year, unless otherwise stated or implied; [52] and any amendment which is in force at the beginning of the relevant assessment year must govern the case though the amendment is made after the income under assessment is earned. [53] In other words, the Income-tax Act as it stands amended on April 1, of a financial year must apply to the assessment for that year. [54] Any amendments in the Act which come into force after April 1, of a financial year, would not apply to the assessment for that year, even if the assessment is actually made after the amendments come into force. [55] However, any amendment of the Act, though effected after the close of the assessment year but before the assessment is made, would still be given retrospective effect and would apply to the assessment, if the amendment is purely procedural and affects the machinery for collecting the tax rather than the tax itself. [56] In other words, the enactment of a procedural provision applies to pending assessments. [57] If after an assessment order is passed but pending an appeal or reference, legislation with retrospective effect comes into operation, the

deciding tribunal must give effect to such legislation. (See under **s 1** , 'Retrospective legislation', 'Partial retrospective operation', and 'Retrospective effect of provision for appeal, revision or rectification'.)

However, capital gains, according to the Gujarat High Court, [58] are not income which accrue from day to day during a previous year, but arise at a fixed point of time, namely, the date of transfer upon the taxable event, unlike profits or gains of a business which accrue at the end of the previous year when the result of the working of the business for the entire year is known. Consequently, on a harmonious interpretation, it is held that for taxation of capital gains, the law to be applied is the law as on the date of the transfer. As regards provisions pertaining to the levy of penalty, the law to be applied is that in force at the date when the default which attracts the penalty is committed. (See under **s 271** , 'Law to be applied is that in force at date of default which attracts penalty'.)

(e) Tax on 'Total Income' of Assessee, Subject to Provisions of the Act .--The tax is on 'the total income of' the assessable entity. The Privy Council said in *Kalyanji Vithaldas v CIT* : [59]

> The words 'income of' are simple words and are capable of wider or narrower meaning; but for the present purpose the Courts are concerned with them as they appear in an Income-tax Act; and under **s 3** or **55** (of the 1922 Act) income is not to be attributed to any one of the five classes of persons mentioned by any loose or extended interpretation of the words, but only where the application of the words is warranted by their ordinary legal meaning.

For instance, where a usufructuary mortgagee is in possession and is entitled to realise and appropriate the whole usufruct of the property, the income from the property arises to the mortgagee and not to the mortgagor. [60]

The charge in respect of the total income is expressly declared to be 'in accordance with, and subject to the provisionsof, this Act'. These words, read in conjunction with the definition of total income in **s 2(45)** , imply three main things:

(a) the income charged is that referred to in **s 5** ;
(b) full effect must be given to the exemptions from tax granted under various provisions of the Act; [61] and
(c) the income should be assessed under the appropriate head and should be computed as prescribed in the Act after making the allowances and deductions provided for the different heads of income. [62]

The correct method of approach is to treat nothing as being charged to tax until by the process of computation laid down by the Act the status of income, profits and gains emerges. [63]

There are special provisions in the Act which deviate from the above rule of computing income, and levy 'presumptive tax' by (a) taking a percentage of gross receipts as net income, or (b) denying deduction of certain expenses legitimately claimable from such gross receipts. Examples of the first category are deleted **s 44AC** (alcoholic liquor, timber and other forest produce), ss 44B and 172 (shipping business of a non-resident), **s 44BB** (exploration of mineral oils by a non-resident), **s 44BBA** (operation of aircraft by a non-resident), and **s 44BBB** (construction work done by a foreign company in connection with a turnkey power project). In the

second category would fall **s 44D** or **s 44DA** read with **s 115A** (royalty and technical fees received by a non-resident or a foreign company). [64]

Mutual Concerns

5. General Principles. --It will be convenient to consider first the general law relating to mutual concerns and then the provisions of this Act which modify the general law.

Under the general law, the surplus accruing to a mutual concern cannot be regarded as income, profits or gains for the purposes of this Act. In *Styles v New York Life Ins. Co.,* [65] Lord Watson said:

> When a number of individuals agree to contribute funds for a common purpose, such as the payment of annuities or of capital sums, to some or all of them, on the occurrence of events certain or uncertain, and stipulate that their contributions, so far as not required for that purpose, shall be repaid to them, I cannot conceive why they should be regarded as traders, or why contributions returned to them should be regarded as profits.

Where the contributors are to receive back a part of their own contributions, the complete identity between the contributors and recipients negatives the idea of any profit, for no man can make a profit out of himself . [66] In *IR v Cornish Mutual Assce Co. Ltd.,* [67] the House of Lords, explaining the above dicta of Lord Watson, laid down that a mutual concern may be held to carry on a business or trade with its members, though the surplus arising from such trade is not taxable income or profit. [68]

Thus, in the case of a mutual insurance association where the surplus goes back to the insured, whether in cash or in reduction of his premium or in enhancement of the sum insured or on winding up, it is in essence merely a return of his own money which he has overpaid and is not a profit at all. [69] 'Sooner or later, in meal or in malt, the whole of the association's receipts must go back to the policyholders as a class, though not precisely in the proportions in which they have contributed to them and the association does not in any true sense make a profit out of their contributions'. [70] In the case of a mutual insurance company or association, if the transactions are of the nature of mutual insurance, the resultant surplus is not income, whether the transactions are with members or with non-members. [71] The principle of mutuality has been accepted in the case of a voluntary social organisation which received offerings (*gurudakshina*) from its members. [72]

The principles governing mutual concerns, so far as they can be drawn from the conflict and diversity of judicial opinion, may be summarised as follows:

(a) Complete Identity between Contributors and Participators. --The crucial test of mutuality was laid down by Lord Macmillan in *Municipal Mutual Ins. Ltd. v Hills* : [73] 'The cardinal requirement is that all the contributors to the common fund must be entitled to participate in the surplus and that all the participators in the surplus must be contributors to the common fund; in other words, there must be complete identity between the contributors and the participators'. 'If this requirement is satisfied, the particular form which the association takes is immaterial'. [74] Explaining this principle, the Andhra Pradesh High Court held in *CIT v Merchant Navy Club* held that, [75] the contributors to the common fund and the participators in the surplus must be an identical body. That does not mean that each member should contribute to the common fund or that each member should participate in the surplus or get back from the surplus precisely what he has paid. The Madras, [76] Andhra Pradesh, [77] Kerala, [78] Punjab and Haryana [79] and Calcutta [80] High Courts have held that the test of mutuality does not require that the contributors to the common fund should distribute the surplus amongst themselves; it is enough if they have a right of disposal over the surplus, and in exercise of that right they may agree that on

winding-up the surplus will be transferred to a similar association or used for some charitable objects. The contrary view has been taken by the Gujarat High Court. [81] Conversely, where there is no such identity between the class of contributors to the common fund and the class of participators in the surplus, the profits of the association would be assessable to tax. [82] *Styles v New York Life Ins. Co.,* [83] is the leading case of a mutual concern, there being complete identity between the class of contributors and the class of participators; while the case of *Last v London Assce Corpn.,* [84] is illustrative of a concern which was chargeable as a non-mutual concern since there was no such complete identity. Both these cases were of insurance business.

Applying the test enunciated Lord Macmillan, the Privy Council laid down in *English & Scottish Joint Co-op. Wholesale Society Ltd. v C Ag IT,* [85] that where an association merely sells goods of its own produce and manufacture to its members and there is no common fund to which the members contribute and in which they participate, the association is not a mutual concern. Lord Normand, delivering the judgement of the Board, said: [86]

> Their Lordships are of opinion that the principle (of *Styles'* case) cannot apply to an association, society or company which grows produce on its own land or manufactures goods in its own factories, using either its own capital or capital borrowed whether from its members or from others, and sells its produce or goods to its members exclusivelyNo matter who the purchasers may be, if the society sells the tea grown and manufactured by it at a price which exceeds the cost of producing it and rendering it fit for sale, it has earned profits which are, subject to the provisions of the taxing Act, taxable profits.

Their Lordships further explained [87] that the decision in *Styles* ' case rested on the concurrence of three conditions: (i) the identity of the contributors to the fund and the recipients from the fund; (ii) the treatment of the company, though incorporated, as a mere entity for the convenience of the members and policyholders, in other words as an instrument obedient to their mandate; and (iii) the impossibility that contributors should derive profits from contributions made by themselves to a fund which could only be expended or returned to themselves.

The Supreme Court in *CIT v Royal Western India Turf Club Ltd.,* [88] reviewed the case law relating to mutual concerns and laid down that an incorporated company which carries on a business and realises money both from members and from non-members for the same consideration, namely, the giving of the same or similar facilities to all alike in the course of one and the same business carried on by it, cannot be regarded as a mutual concern. In that case, fees for admission to a race-course charged to its members by a company carrying on the business of horse racing, were held to be assessable as much as fees paid by the public for admission to the same race-course, the fact that there was a separate enclosure for members being held to be immaterial.

On a further exhaustive survey of most of the above important rulings, the law in its different facets is now well summed up by the Supreme Court in *CIT v Bankipur Club,* [89] thus:

> Where a number of persons combine together and contribute to a common fund for financing of some venture or object and in this respect have no dealings or relations with any outside body, then any surplus returned to those persons cannot be regarded in any sense as profit. There must be complete identity between the contributors and the participators. If these requirements are fulfilled, it is immaterial what particular form the association takes. Trading between persons associated together in this way does not give rise to profits which are chargeable to tax. Where the trade or activity is mutual, the fact that, as regards certain activities, certain members only of the association take advantage of the facilities

> which it offers does not affect the mutuality of the enterprise. (But) if the object of the assessee company claiming to be a 'mutual concern' or a 'club', is to carry on a particular business and the money is realised both from the members and the non-members, for the same consideration by giving the same or similar facilities to all alike in respect of the one and the same business carried on by it, the dealings as a whole, disclose the same profit-earning motive and are alike tainted with commercialityand the resultant surplus is profit-income liable to tax.

(b) Trade with Members. --Where an association or company trades with its members only and the surplus out of the common fund is distributable among the members, there is no mutuality and the surplus is assessable to tax as profit, the reason being that there is no complete identity between the contributors and the participators since those members who have not contributed to the surplus as customers are nevertheless entitled to participate in the surplus. [90] However, if such an association or company distributes the surplus among the customers as such, there would be complete identity between the contributors and the participators, for only those members would be entitled to participate in the surplus who have contributed to it as customer. [91]

(c) Effect of Incorporation.--As a general rule, the fact that a mutual association is incorporated as a company would not affect its mutual character or the non-liability of the surplus to tax, for incorporation does not destroy or even impair the complete identity between the contributors and the participatory. [1] Yet in peculiar circumstances of certain cases, incorporation has been held to make a difference. [2] An incorporated company may make a taxable profit out of its own members. [3]

(d) Mutual and Non-mutual Activities.--The same association may carry on 'mutual' activities resulting in a non-taxable surplus and also non-mutual activities resulting in taxable profits. [4] Even though the assessee company was formed by certain shopkeepers essentially for the benefit of members, the principle of mutuality was not applicable to interest earned by the assessee on fixed deposits with banks, particularly when various kinds of business could be carried on by the assessee under its memorandum. [5]

(i) Mutual Benefit Funds.--Cases of 'mutual benefit' funds or societies of diverse sorts have arisen in the State of Tamil Nadu and they have been held to be non-mutual concerns by applying the general tests stated above. [6] The fact that a ' *Nidhi* ' is notified under **s 620A** of the Companies Act does not debar the department from inquiring whether it satisfies the test of mutuality, and assessing it if it does not. [7]

(ii) Members' Clubs.--The consensus of judicial opinion which is now firmly established by the Supreme Court [8] is that any surplus accruing to a members' club from the subscriptions and charges for various conveniences paid by members is not income or profit at all, nor can a social club be deemed to trade as far as its dealings with its own members are concerned. [9] Finlay J said in *National Assn of Local Govt Officers v Watkins,* [10] 'It is a fallacyto say in the case of such a club that, where a member orders a dinner and consumes it, there is any sale to him. There is not a sale. The fundamental thing is that the whole property is vested in the membersThe members have a right to participate in the wholeThere isno trade among the members. They cannot trade with themselves.' The position would be the same even though the club may be incorporated as a company [11] or registered as a society. [12] However, a club is taxable on the profit derived from subscriptions and charges paid by non-members, [13] and on the income derived from its capital assets and investments. [14] However, a club which has no commercial activities is not taxable in respect of the charges it makes to its members for providing them temporary accommodation in its premises. [15] Where a club is an incorporated company carrying on business, it may be taxable on the moneys received from its members as well as non-members in the course of its business. [16]

If, however, the club is not a members' club but is a proprietary club, in other words if the club is owned not by the members themselves but by an outsider, the proprietor of the club would be regarded as carrying on a business and would be assessable on the profits earned by running the club. [17] This would be so even though the proprietor may be a limited company, some of the shareholders of which are also members of the club. [18]

The Supreme Court has now held that when a club earns interest from fixed deposits, the thread of mutuality is broken and the interest is chargeable to tax. [19] Even if the banks are corporate members of the club, it was held that the moneys deposited with the bank are used in its lending business and profits are earned thereon, breaking the chain of mutuality. This decision is incorrect for a reason not discussed in it. The relationship between a banker and customer is one of a debtor and creditor. Hence, when the club deposits a sum with its member bank, it is, in law, loaning a sum of money to its member. The bank is bound to repay the money with interest for the use of the money. Whether the bank makes profits from its commercial operations or not, its obligation to pay interest to the club on the deposit is not discharged. This is similar to the case where a club makes a profit out of renting accommodation to its members. The member might entertain a business guest in that accommodation and may make eventually a profit out of that transaction, but that does not affect his relationship with the club, which is still that of a member of a mutual concern.

The Supreme Court has also held that the "object" of the club is not furthered by the act of placing the surplus funds in a fixed deposit, since no infrastructure or service is provided using this surplus. There is no requirement in income-tax law that a mutual concern, especially a members' club must have any designated "object" or "purpose".

6. Statutory Provisions regarding Mutual Concerns. --The foregoing principles governing mutual concerns in general have been modified by express provisions in the Act:

(a) Mutual Insurance Associations.--The definition of income in **s 2(24)(vii)** of this Act expressly includes any surplus accruing to life as well as non-life mutual insurance concerns and thus supersedes the above-cited cases where such surplus was held to be not taxable as profit. [20] The principle of those decisions may now be usefully invoked only in cases of mutual concerns engaged in activities other than insurance.

(b) Trade or Professional Associations.--A trade, professional or similar association may be a mutual concern. [21] **Section 28(iii)** enacts that 'income derived by a trade, professional or similar association from specific services performed for its members' shall be taxable as business profits. Under **s 2(24)(v)** , any sum chargeable under **s 28(iii)** is deemed to be income. The object of these provisions seems to be to tax as profit the surplus arising from specific services rendered to members by a mutual trade, professional or similar association which otherwise may not be liable to tax in view of the general principles applicable to mutual concerns. [22] (See further under **s 28(iii)** 'Some incomes of approved professional associations or institutions are exempt from tax under **s 10(23A)** '.) **Section 44A** deals with the case where receipts by a trade, professional or similar association from its members, by way of subscription or otherwise, fall short of the expenditure incurred by the association for the purpose of protecting or advancing the common interests of its members.

(c) Co-operative Societies.--Apart from special statutory provisions, the liability of a co-operative society to tax depends upon whether it is a mutual concern earning non taxable surplus or whether it is a non-mutual concern earning taxable profits. This may be determined upon the general principles enunciated above. [23] In *English & Scottish Joint Co-op. Wholesale Society Ltd. v C Ag IT* , [24] a co-operative society which sold tea grown and manufactured by itself to its members was held by the Privy Council to be a non-mutual concern.

A housing society can be treated as a mutual concern if the requisite tests are fulfilled. Consequently, the transfer fee payable by outgoing members for extension of amenities to members has been held not to be taxable. [25] Applying the principles of mutuality, the amounts paid towards the common amenity fund for repairs as well as non-occupancy charges received by a co-operative society would not be liable to tax. [26]

A co-operative society is defined in **s 2(19)** as meaning a co-operative society registered under the **Co-operative Societies Act** , 1912 or under any state law for the registration of co-operative societies. Irrespective of the question whether a co-operative society is a mutual or a non-mutual concern, certain incomes

of co-operative societies are exempt from tax under **s 80P** . Under **s 80Q** *, prior to its deletion with effect from April 1, 1973, a member of a co-operative society was exempt from tax in respect of any dividends received by him from the society. (See under **s 80P** and the deleted **s 80Q** .) Under **s 2(24)(vii)** the profits and gains of any business of insurance carried on by a co-operative society, even if it is a mutual concern, are made taxable in all cases as income and are to be computed in accordance with the rules in the First Schedule. Under **s 27(iii)** a member of a co-operative society to whom a building or part thereof is allotted or leased under a house building scheme of the society is deemed to be the owner of that building or part of that building is assessable as such.

Despite the provisions of **s 80P** which exempt the income of Indian co-operative societies from tax, the question of applying the general principles governing mutual concerns to co-operative societies would still arise where the co-operative society is registered abroad.

Reference to Court: The question whether the persons dealing with each other are a 'mutual club' or carrying on a trade activity is largely a question of fact. [27]

Income, Profits and Gains

7. Income, Profits and Gains. --The object of the Act is to tax 'income', a term of formidably wide and vague import. It is defined by **s 2(24)(i)** as including profits and gains, but the expansion is more a matter of words than of substance. [28] The word 'income' is an expression of elastic ambit, and courts when describing income have almost always qualified their description by saying that it is not exhaustive. As to the meaning of the word 'income', reference may be usefully made to English decisions, [29] but it must be remembered that the charging words of this Act are not the same as the charging words of the English statute. [30]

'Income' is a more general term than 'profits' or 'gains'. [31] The word 'income' is not limited by the words 'profits' and 'gains'. [32] An element of profit is not an essential ingredient of a receipt to be taxable as an income. [33] A receipt may be taxable as income, although it may contain no element of profit or gain. Where a man aged 47 transferred an estate worth two crores rupees for a relatively small annuity of Rs. 2,40,000 for life, the annuity could not constitute or provide a 'profit' or 'gain' to him, but all the same it was taxable as income. [34] The taxability of income would not be affected by the fact that the income is derived from the exercise of statutory power [35] or the fact that the payment is disallowed in the hands of the payer. [36] Income includes not only money payment, but also the value of any benefit or perquisite, whether convertible into money or not. [37] Even an occasional payment without any regularity can be income under the Act. [38] Further, in order to be assessable under the Act, income must actually accrue or arise: income, which the assessee could have, but has not earned, cannot be assessed. [39] An amount of expenditure which is disallowed in the assessment and then written back in the books in the subsequent year is not an income and therefore not assessable under the Act in the subsequent year. [40] An outgoing cannot be treated as income. [41] A contribution to the corpus of the assessee is a capital receipt. [42]

Profits or gains mean something which is in the nature of interest or fruit, as opposed to principal or tree. [43] 'Gains' is really the equivalent of 'profits'. [44] The profit of a trade or business is the surplus by which the receipts from the trade or business exceed the expenditure necessary for the purpose of earning those receipts. [45] The tax is upon income, profits and gains; it is not a tax on gross receipts. [46] An excess accruing to the assessee due to fortuitous circumstances or as a windfall is not taxable even though remotely connected with business. [47] Likewise, a mere provision in the accounts towards estimated profit on exchange transactions is not assessable as profits. [48] Similarly, where advance is received for adjustment against running bills and the amount is lying in the foreign exchange account of the assessee, the mere conversion of that amount into Indian rupees at the end of the year for accounting purpose does not give rise to assessable income. [49] (For a discussion of profits and gains in connection with business, profession or vocation, see under **s 28(i)** , 'Profits and gains'.) The expression 'profits and gains' is not limited to business only but is used in the Act with reference to other sources

of income as well. [50]

The Act describes sources of income and prescribes methods of computing income, but what constitutes income it discreetly refrains from saying. The definition of 'income' in **s 2(24)** is inclusive and not exhaustive; it adds artificial categories (including capital gains) to the natural connotation of 'income' without throwing any light on the general concept of the word. 'Income' includes not only those things which the interpretation clause declares that it shall include, but such things as the word signifies according to its natural import. [51]

A Full Bench of the Allahabad High Court laid down in *Amrit Kunwar v CIT*, [52] and the Bombay High Court in *Vijaykuverba v CIT*, [53] that income need not necessarily arise from any business activity, investment or outlay, or any enforceable obligation to pay--it may be voluntary or may be attributable to some custom, usage or traditional obligation; but mere casual payments or windfalls do not constitute income, [54] and therefore, voluntary payments in order to be taxable in the hands of the recipient as income must have an origin which a practical man would regard as a real source of income. Mere offerings made at the feet of a deceased saint would not be taxable as the income of his descendants. [55] (See under **s 10(3)** , 'Voluntary payments: Testimonials and personal gifts: Regular allowances'.)

The definition of income has been approached in three decisions of the Privy Council. Sir George Lowndes, in *CIT v Shaw Wallace*, [56] gave the following definition of 'income':

> Incomein this Act connotes a periodical monetary return 'coming in' with some sort of regularity, or expected regularity, from definite sources. [57] The source is not necessarily one which is expected to be continuously productive, but it must be one whose object is the production of a definite return, excluding anything in the nature of a mere windfall. Thus income has been likened pictorially to the fruit of a tree, or the crop of a field. It is essentially the produce of something which is often loosely spoken of as 'capital'. But capital, though possibly the source in the case of income from securities, is in most cases hardly more than an element in the process of production.

This definition was followed in *Gopal Saran Narain Singh v CIT* , [58] by Lord Russell of Killowen who, however, added the important amplification: 'Anything which can properly be described as income, is taxable under the Act unless expressly exempted.'

In *Kamakshya Narain Singh v CIT* , [59] Lord Wright repeated the above observations of Sir George Lowndes and Lord Russell, and remarked:

> Income, it is true, is a word difficult and perhaps impossible to define in any precise general formula. It is a word of the broadest connotationSir George Lowndes speaks of 'income' being likened pictorially to the fruit of a tree or the crop of a field. But it is clear that such picturesque similes cannot be used to limit the true character of income [60] Income is not necessarily the recurrent return from a definite source, though it is generally of that character. Income again may consist of a series of separate receipts, as it generally does in the case of professional earnings. The multiplicity of forms which 'income' may assume is beyond enumeration.

In the light of the above authorities, the position may be summed up as follows:

The categories of income are never closed. It would be impossible to define income precisely without

excluding some species of it. The effect of the definition of 'income' given by the Privy Council in *Shaw Wallace* 's case has been whittled down to a very large extent by the subsequent pronouncements of the same tribunal. The definition given in that case should be taken in conjunction with the facts of that case. [61] Income is not necessarily a recurrent return from a definite source, [62] --in fact it may never recur at all and the source may never yield a periodic return. An isolated adventure may constitute business. [63] Even a casual and non-recurring receipt may be income, [64] though it is partly exempt from taxation in certain circumstances under **s 10(3)** . Anything which can properly be described as income is taxable under the Act unless expressly exempted. [65] That perhaps is the best definition of taxable income, from the practical, though not from the logical, point of view.

8. Real and Not Hypothetical Income Chargeable. --In general, unless the definition of 'income' has been artificially expanded by specific language of the statute, the concept of 'real income' would come into play. But, it has been held that the concept has to be applied depending on the specific facts and circumstances, and no straitjacket formula can be evolved. [66] Merely because the amount was shown as a surplus in the profit and loss account when the assessee did not actually receive any income, it would not constitute income under **s 2(24)** . [67] Profits or gains under the Act must be understood in the sense of real profits or gains, that is to say on the basis of ordinary commercial principles on which actual profits are computed and the manner in which no commercial man would misunderstand. [68] It is the "real income" which has really accrued or arisen to the assessee that is taxable. This has to be ascertained by taking the probability or improbability of realization in a realistic manner. The conduct of the party in treating the income in a particular manner is also a material evidence of the fact whether income has accrued or not. The concept of income is a well accepted one but must be applied with circumspection. [69] After correctly setting out the concept of real income, the majority wrongly held that interest on sticky loans would accrue to the banks following the mercantile system of accounting despite three circulars to the contrary. [70] The incorrectness of this view was explained in a later decision. [71] It has also been wrongly held that accrued income/book profit is "real income". [72] Entries relating to interest payable to the two members of the association were posted merely for apportionment of part of the loss suffered by the sugar mills; they represented no real income to the two members. [73] But the concept of real income cannot be applied to defeat, whittle down or qualify the express provisions of the Act and the Rules. [74]

When a certain income was shown as interest income from another company but this entry was reversed due to a change in the factual situation, the initial entry was only about a hypothetical income which did not materialize. Consequently, the reversal was rightly done and this entry could not be taxed as it is only real income that will be liable to tax. [75] Similarly, when the enhanced charges for supply of electricity were, in special circumstances, unlikely to materialize, no real income accrued and the entries made were only hypothetical income. [76]

The income tax is a tax on the real income, that is profits arrived at on commercial principles and subject to the provisions of the Act. As a business concern, the real profits have to be ascertained on the principles of commercial accountancy. On facts, the profits of the electricity undertaking had to be computed in accordance with the provisions of electricity laws. [77]

The management agency commission that had accrued in one assessment year was foregone on grounds of commercial expediency in the following assessment year. It was argued that each year is separate and any surrender or giving up in the subsequent year cannot be taken note of. In a judgment that deserves to be fully read, the Bombay High Court [78] held that the accrual of commission, the making of the accounts, the legal obligation to give up a part of the commission and foregoing of the commission are not disjointed facts. There is a dovetailing about them which cannot be ignored. There is no doubt that considerations of equity or hardship cannot control the statutory provisions of the Act and it is also axiomatic that each year is self-contained period for assessing profits and gains of business but there is nothing in these axiomatic rules which militates against the simultaneous application of another basic principle of tax law which requires the court to see that ultimately it is the real income of the assessee which alone is brought to tax and not any artificial or notional income that

may be said to have accrued to them. The principle of real income cannot be negated simply because surrender or concession or rebate of the management agency commission had taken place after the closure of an accounting year. The two rules that income-tax is annual in its structure, meaning thereby that, for computation, each year is a distinct self-contained unit, and the other that the income to be taxed is the real income of the assessee are not incompatible or irreconcilable.

9. Tax-free Income. --Where income is received free of tax, the amount of the tax should be added and brought in, and the gross income should be included in the total income of the recipient, [79] unless there is a specific statutory provision like **s 10(6A)** to avoid grossing up. (For commentary on various tax-free receipts see under **s 15** , 'Tax-free salary'; **s 28(i)** , 'Tax-free business income'; **s 56(1)** , 'Tax-free receipts'; **s 161** , 'Tax-free payment made to non-resident'; and ss 237-40, 'Tax-free income'. See also **s 195A** .)

10. Income Tainted with Illegality. --The taint of illegality or wrong-doing associated with income, profits or gains is immaterial for the purpose of taxation. [80] Once the character of an enterprise has been ascertained as being of the nature of trade, the person who carries it on cannot found upon elements of illegality to avoid tax. [81] In the leading case of *Minister of Finance v Smith,* [82] Lord Haldane said that the Income-tax Acts are not necessarily restricted in their application to lawful businesses only. [83] The revenue merely looks at an accomplished fact; by bringing the profits to tax it does not condone or take part in the illegal enterprise. [84] The assessee may be prosecuted for the offence and at the same time taxed upon the profits arising out of its commission. [85] Profits arising from a trade which necessarily involves fraud upon the customs authorities,55 or from illicit trafficking in drugs, [86] illicit trafficking in liquorcontrary to prohibition laws, [87] keeping automatic gaming machines for public use, [88] illegal bets taken by bookmakers on race-courses, [89] street betting or betting through the post, [90] or wagering agreements, [91] are all chargeable to tax. They are taxable as profits of business under **s 28** , even if the business involves the perpetration of crimes. The profits of a man who lives by regularly receiving and re-selling stolen goods would be taxable. [92] 'Money embezzled is a gain to the embezzler and therefore, falls within the wider definition of 'income' under the Act'. [93] *Pugrees* or 'abwabs' illegally exacted from tenants by landlords, [94] or income derived by trustees from forbidden investments or acts amounting to breaches of trust, [95] are also within the purview of the Act. Similarly, losses arising from an unlawful business are allowable. (See under **s 29** , 'Losses in unlawful business', and under **s 37** , under 'Wholly and exclusively for the purposes of the business', 'Expenditure tainted with illegality'.)

The invalidity of a partnership does not affect its liability or that of its members to assessment. [96] An illegal partnership may be assessed as an association of persons. (See under 'Illegal partnerships', and 'Illegal association'.)

11. Where Title to Income is in Dispute. --Income is taxable notwithstanding the pendency of another's claim to it. Where money has been received, a rival claim or a threat of litigation cannot be regarded as reducing the interest of the recipient to a contingent basis. The recipient is taxable although there may be a rival claim to the source of the income and the recipient may some day have to give up the income and account for what he is taxed upon. [97] On the other hand, a mere claim by a person against another who has actually received the money, is not sufficient to make income accrue to the claimant and render him liable to tax. In *Godhra Electricity v CIT,* [98] the Supreme Court held that a claim for increased rate of electricity which was not received due to litigation did not result in accrual of income. (See under **s 5** , 'Time of accrual of income' and under **s 145(1)** , 'Disputed claims by or against assessee'.)

The mere existence of a dispute as to title, even where a suit has been filed, cannot of itself hold up an assessment. Where the assessment is on income from property under **s 22** , the department has *prima facie* the power to decide whether the assessee is the 'owner' of the property, without waiting for the determination of any suit filed in respect of the property. [99] (See further under **s 22** , 'Title to property in dispute'.)

In a suit between two or more parties concerning the title to property or income, the revenue cannot be

brought in as an additional defendant against the wish of any of the original parties; [1] though in a fit case, the court may invite the counsel for the revenue to address the court as *amicus curiae.* [2]

The Comptroller and Auditor-General of India (CAG) observed that the funds with the assessee, a State Industrial Undertaking, belonged to the Delhi Administration and interest on those funds also did not belong to it. Consequently, entries were duly reversed; these amounts could not be treated as income. [3]

12. Taxable Income--Effect of Other Laws. --Under **s 45Q** of the **Reserve Bank of India Act** , 1934, directions were issued in 1998 prohibiting Non-Banking Financial Companies (NBFCs) from taking credit of interest on Non-performing Assets (NPA). Briefly, these directions stipulated that if more than two instalments had not been paid in a hire purchase or lease transaction, the interest portion should not be treated as income even though the NBFCs followed the mercantile system of accounting. In other words, if a customer defaulted in payment of more than two instalments, the interest component of the EMI (Equated Monthly Instalment) could be taken credit only when it was actually paid. These interest amounts would not be treated as "income" for the purpose of the **Companies Act** , 1956. This was a major departure from the rules of the mercantile system of accounting. In addition, the RBI Directions, 1998 stipulated that the amounts which were outstanding to be shown as "Provision for NPA" in the Balance Sheet and could not be netted. Before the RBI Directions, the amount to be set apart as provision for NBA and the amount to be written off as debt itself was left to the discretion of the Board of Directors of the individual NBFCs. With the 1998 Directions, all NBFCs had to show the instalments which had not been paid for two months as NPA in the Balance Sheet because this would result in disclosure of the outstanding amount. If the amount which had not been received was netted, the shareholders and other institutions would not know the extent of NPAs. The Revenue sought to add back the provision for NPA shown in the balance sheet thereby treating it as part of income. It was contended that the provision for NPA, in terms of the RBI Directions, 1998, had to be shown as such in the balance sheet and could not be treated as income. Indeed, the NBFCs were prohibited from crediting the accrued income with regard to non-performing assets. If the receipt was not an income under the mandatory provision of the RBI Directions, 1998, the Department could not add back the provision for NPA by resorting to **s 36(1)(vii)** . Despite setting out the proper question, [4] the Supreme Court failed to answer this question and ruled that the provisions of the RBI Directions and the Act operated in "different fields". It further erroneously held that the provision for NPA in terms of RBI Direction did not constitute expenditure on the basis of which deductions could be claimed by the NBFCs under **s 36(1)(vii)** . It is submitted that the provision for NPAs is shown in the balance sheet only for the purpose of compliance with the RBI directions. This could not be disallowed under **s 36(1)(vii)** and the quantum of the provision added back. Arguments relating to the real income theory were also brushed aside and the Department argued that the provision for NPA was in substance a "Reserve". It is beyond comprehension that amounts which represent instalment due from defaulters and which are unlikely to be received could be treated as a "reserve". The Supreme Court failed to note the *non-obstante* clause in **s 45Q** which made the provisions of Chapter III-A prevail over any other law for the time being in force. It failed to address a simple but fundamental question: if amounts that are not received are prohibited from being credited to P&L account, can they be treated as income merely because they are required to be shown as a "provision"? The Supreme Court, it is submitted, failed to decide the real issue involved but went on to hold that the RBI directions could not overrule the provisions of the Act. Paradoxically, the Supreme Court held that the RBI Directions, 1998 could have an overriding effect over the **Companies Act** , 1956 but not over the Act because they operate "in different areas". A *non-obstante* clause overrides all other laws irrespective of whether they operate in one area or in different areas.

13. Reimbursement of Loss or Expenditure is not Income. --Where the loss or expenditure incurred by a subsidiary company in the course of its business is partly or wholly reimbursed by the parent company, the amount received by the subsidiary is not taxable as its income and it is entitled to deduction of the entire loss or expenditure. [5] Similarly, where a non-resident company incurs expenditure on research carried on by it for the benefit of itself and its subsidiaries and associated companies all over the world, the portion of expenditure

reimbursed to it by those companies cannot be treated as the income of the non-resident company. [6] Where an assessee receives consideration from a non-resident company for rendering certain services, along with reimbursement of certain expenses incurred, such reimbursement of expenses has been held to be not a revenue receipt exigible to tax. [7] (Cf under **s 37** , 'Residuary head of revenue expenditure'.)

City compensatory allowance, which is paid to reimburse an employee the extra expenses he has to incur by reason of his posting at a particular place, is taxable income. [8] It was brought within the definition of 'income' by **s 2(24)(iii-b)** , inserted with effect from 1-4-1962.

14. Mere Relief from Expense is not Income. --Mere relief from expense is not income. A person is chargeable to tax not on what saves his pocket but on what goes into his pocket. [9] In *Re John,* [10] the assessee and his brother held all the debentures of a company. In a suit by the brothers on the debentures, the assets of the company were sold for a sum a long way below the sums owed by the company under the debentures. The commission of the auctioneer at the court-sale would have been five per cent, but the court relieved the debenture holders of the payment of this commission by allowing the assessee to act as the auctioneer. The department treated this five per cent commission which amounted to Rs. 1,04,000 as income of the assessee and assessed him thereupon. A Full Bench of the Allahabad High Court held that the relief granted to the auctioneer could not be regarded as his income.

15. Whether Remission of Debt is Income. --There can be no reopening and adjustment of accounts in cases where a finally ascertained debt or liability is subsequently remitted in whole or in part, nor can such remitted amount be treated as income of the year of remission under the general law, apart from the provisions of ss 41(1) and 59(1) which are considered below. (See under **s 5(1)(b)** , 'No reopening and adjustment of accounts'.) In *British Mexican Petroleum Co. Ltd. v Jackson* , [11] the assessee company entered into a contract with an oil-producing company for the purchase of petroleum over a period of years. The unpaid price of the oil supplied was debited in the accounts. The next year, in view of the adverse effect of a business slump on the assessee company, the producing company accepted payment of a part of the debt and released the assessee company from its liability to pay the balance remaining due. The House of Lords held that the amount remitted could not be included as a revenue receipt in the accounts of the year of remission and that the accounts of the preceding year, where the whole debt was debited, should not be reopened and adjusted by reference to the remission. Lord Macmillan observed, 'I cannot see how the extent to which a debt is forgiven can become a credit item in the trading account for the period within which the concession is made'. This case has been followed in India also. [12] When the assessee did not credit interest on dues from sister concerns because recovery was impossible, interest could not be taxed on a notional basis. [13]

However, the above principle of general law is superseded by **s 41(1)** which expressly makes the amount remitted taxable as the income of the year of remission. Under that sub-section, where in computing business profits an allowance or deduction has been made in the assessment for any year in respect of any trading liability and subsequently the assessee obtains some benefit in respect of such trading liability by way of remission, the amount remitted would be deemed to be business profits and to have accrued in the year of remission. Under **s 59(1)** the same provisions apply in respect of assessment under the head 'Income from other sources'. (See under **s 41(1)** .)

16. Unclaimed Deposits or Balances due to Clients, Employees or Others, and Advances. --If deposits received by a businessman in substance partake more of the nature of trading receipts than of security deposits, such deposits, if unreturned, would be taxable as income. [14] However, a deposit referable to fixed capital and not received in the course of business is a capital receipt and forfeiture of such deposit would not be taxable as income. [15] Amounts collected under a deposit scheme are capital in nature. [16] When the assessee had appropriated 97% of the first year's deposits as part of income and 3% towards capital account, it could not claim that the entire receipt towards the first year's subscription was capital receipt. The assessee could not blow hot and cold. [17]

It cannot be laid down as a matter of law that an amount, which was initially not received as a trading receipt, can never become a trading receipt. A trading receipt arising in the course of business, though treated as a deposit and of capital nature when received can, nevertheless, become the assessee's own money by efflux of time and will be assessable as a trading receipt when it is credited to the profit and loss account and there is no existing liability to repay. [18] Cess collected from customers but not paid over to the government has been held to be assessable as a trading receipt. [19] Where an assessee charged an excess amount over and above the maximum permissible sale price and there is no obligation to refund the excess price so collected, such excess was also held to be assessable in the hands of the assessee. [20]

However, it has also been held that a receipt which is not in the first instance a trading receipt cannot become a trading receipt by any subsequent process. [21] In *Morley v Tattersall,* [22] a firm of auctioneers had large unclaimed balances of their clients in their hands. Several years' accumulations of those balances were divided by the firm among the partners. Held, they were not trading receipts and could not be taxed as income. The quality and nature of a receipt for income-tax purposes is fixed once and for all when it is received. The unclaimed balances, when first received from the auction-purchasers, were obviously liabilities and no subsequent operation or alteration in the accounts could turn them into trading receipts. Recently, the Supreme Court, in the *Travancore Rubber v CIT,* [23] reconciled the legal position and reiterated that unless a different quality is imprinted on the receipt by a subsequent event, a receipt which is not in the first instance a trading receipt cannot become a trading receipt by any subsequent process.

The Supreme Court has also, in *CIT v Sugauli Sugar,* [24] expressly approved the decision of the Bombay High Court that unclaimed wages do not become income merely because the amount is credited to the profit and loss account when they become time-barred. [25] Likewise, brokerage collected from constituents to be paid to brokers but remaining unpaid, [26] or the excess premium collected by an insurance agent from policyholders and not refunded to them, or the excess of the sale price over the levy price of sugar fixed by the government which the assessee is conditionally permitted by the court to collect pending litigation challenging the legality of the government's action and which excess he is legally bound to repay to the purchasers under the court's decision going in his favour, [27] --have been held not to be assessable as business or professional income. Money deposited with a solicitor by his clients and remaining unrefunded, [28] or interest earned by him on such money, [29] is not his income, because he stands in a fiduciary position to his clients. A refundable deposit or other similar receipt in the course of business which is to be repaid is not assessable as income since such deposit or receipt does not belong to the assessee. [30]

While deciding such debatable issues, the reconciliation between these seemingly conflicting judicial opinions will require a close examination of the facts of each case. (See also under **s 28** , 'Non-refundable deposits'. For cases of remission of debts due by the assessee, see above, and under **s 41(1)** .)

17. Sales Tax or other Duty Collected from Customers. --The principle of *Morley v Tattersall* , [31] does not apply to sales tax or other duty, *e.g.* , excise or export duty, which is collected by a dealer from his customers as part of the consideration for sale of goods. It is well settled that such a tax or duty is part of the dealer's trading or business receipts, even if the tax or duty is charged separately or credited to a separate account in the dealer's books; while the liability to pay the tax or duty to the state would (apart from the special provision of **s 43B**) be deductible as a business expense in the year in which it arises or is discharged, depending on the dealer's method of accounting. [32] Likewise, such tax or duty allowed as a deduction in the past and refunded by the state in a later year may be deemed under **s 41(1)** to be the income of the year of refund, unless the dealer pays it back to the customer. [33] Sales tax collected and credited to a separate account but neither paid to the government nor refunded to the customers is assessable as trading receipt. [34] However, where a commission agent collected sales tax and paid it to the government, and subsequently, when sales tax was found not to be payable, it was held that the refund received was not assessable in the hands of the agent as he acted on behalf of his principal and not on his own account. [35] Further, where an assessee collects certain extra amount towards sales tax from registered dealers treating them as unregistered dealers for the time being for

want of proof, such extra collection would be a deposit to be repaid later on production of proof, and hence, not assessable as income. [36] Likewise, where sales tax is collected by a broker and auctioneer of tea (not a purchaser or seller of tea) who does not reflect tea sales in its accounts, the sales tax so collected and remaining unpaid is not assessable as trading receipt in the hands of such assessee. [37] A part of sales tax collected and then retained as an interest free loan as per a government order is not taxable. [38]

Further, in a case where excess sales tax was retained by the assessee and the Supreme Court ordered refund of the sum with directions to donate to charity that portion of the excess which was not refundable, it was held that the excess sum did not accrue to the assessee and could not be assessed in his hands. [39] This decision can be supported on the well-settled principle that so long as a receipt of an amount is clearly associated with a liability to refund that amount, such receipt cannot be categorized as income. [40] The assessee, in the course of his business of hire purchase of motor vehicles, collected the entire sales tax on the vehicle at the beginning of the transaction. The sales tax amount was credited to a contingency account and sales tax was paid only at the time of the last instalment. The actual sales tax was paid on the depreciated value of the vehicle and was much lesser than the actual amount collected initially. Since there was no tax liability when the amount was collected from the customer, it had to be treated as income in the assessment year in which the amount was collected and credited to the contingency account. The fact that it was credited to a contingency account and then transferred to the sales tax account would make no difference. [41] Amount collected as sales tax and kept as a deposit pending litigation with sales tax authorities was taxable income as there was nothing to show that the monies were kept in a separate fixed deposit and had not been used by the assessee for its business purposes. [42] But this decision has not been properly applied in two later cases. [43] If the amount is kept in a separate deposit account and can be demonstrated not to have been used for the assessee's business, the amounts so collected cannot be treated as income. It is no consolation to tell the assessee that amounts will be allowed as a deduction when the amounts are paid to the sales tax department. To avoid controversy, it is advisable to ensure that interim orders of a court or tribunal stipulate that amounts collected pending a dispute will be kept in a separate account and not used in the assessee's business. Luxury tax collected would be a trading receipt and allowed as a deduction under **s 43B** when it is paid. [44] House tax collected from house owners by the builder and paid to the municipal corporation cannot be taxed as his income. [45]

18. Excess Collections in case of Controlled Commodities. --Sugar factories, on the basis of interim orders of the High Courts, sold sugar in excess of the levy price. The High Court did not impose any condition for refunding the amount or keeping it in a separate account. Therefore, the excess collection in the year of receipt would be a trading receipt and liable to tax. The fact that the excess collections were later to be transferred to a levy Equalisation Fund would not have any bearing on the taxability of amount in the year of collection. If the excess amount collected was subsequently passd on to the State Government or refunded, the assessee would be entitled to claim deduction for the amount so paid or deducted. [46] The Supreme Court pointed out that the essential distinction in the three earlier High Court decisions was that the amount collected in excess was hedged in by conditions for refunding the amount. [47] The excess price was not income when it was collected under an interim order and on furnishing bank guarantee. [48]

19. Tax Incentives--Whether Capital or Revenue in Nature. --It is the object with which the subsidy or incentive is given that determines whether it is revenue or capital in nature. The Supreme Court called this the "purpose test" and ruled that the time when the subsidy was paid, the source and the form of the subsidy was immaterial. If the object of the subsidy or incentive is to enable the assessee to run its business more profitably, then it is revenue in nature. On the other hand, if the subsidy or incentive is for setting up a new unit or expanding the existing unit, the receipt would be capital in nature. Applying the purpose test, a scheme that provided for rebate of excise duty and remission of purchase tax for setting up new sugar unit or for expansion of existing unit was held to be capital in nature. [49] On the other hand, subsidy given by way of assistance for carrying on trade or business to meet recurring expenses and not for acquiring capital assets would be revenue in nature. [50]

20. Modvat/Cenvat Credit not Income. --Merely because Modvat Credit is an irreversible credit available to manufacturers upon purchase of duty paid on raw material, it is not income which is liable to be taxed. [51]

21. Income in Money's Worth or Equivalent of Cash. --Income, profits and gains may be realised in the form of money's worth as well as money, in kind as well as in cash. If the holder of a security, the contractual income from which is money, receives from the person liable to pay that money something of money's worth instead of money, the receipt of the equivalent of cash would be receipt of income arising from the security. In *Scottish & Canadian General Investment Co. Ltd. v Easson,* [52] interest due on bonds issued by an old company was held to be realised when debentures of a new company were received in place of the interest. What is taxable as dividend may be paid in money's worth by the delivery, say, of goods or securities or shares in another company. (See under **s 2(22)** , 'dividend'.)

As Lord Halsbury LC observed in *Tennant v Smith,* [53] profits include anything capable of being turned into money from its own nature. This is the general law, apart from the fact that even certain things which are not capable of being turned into money from their own nature--e.g. rent-free accommodation to an employee [54] or any benefit (even though not convertible into money) obtained from a company by a director or by a person having a substantial interest in the company or by a relative of the director or such person [55] --have by statute been artificially deemed to be income. The essence of the matter is that there must be an actually realised or realisable profit, [56] though the profit may not be immediately realisable. [57] When a company sells its trading assets for fully-paid shares in another company, the profit on the transaction is assessable although no cash passes, [58] and even though the shares are neither realised nor realisable later. [59] The fact that they cannot be realised at once may reduce their present value but that is no reason for treating them as though they had no value until they could be realised. [60] Where shares are allotted to the directors or employees of a company at face value when the market value is higher, the allottees are assessable to tax on the difference between the par value actually paid for the shares and their market value. [61] The same principle would apply even if the shares are issued to the employees with a condition that they are not to part with the shares without the permission of the directors of the company so long as they remain servants of the company, but in this case the market value would have to be taken subject to diminution in value caused by the restriction under which the allotment is accepted. [62] These principles do not apply where the shares are allotted to the directors or employees in their capacity as shareholders of the company. [63] However, when the assessment is under the head 'business', profits are to be computed according to the principles of commercial accounting. If a dealer in shares or a financier is granted an option to buy shares at par at a future date and he exercises the option at a time when the shares stand at a premium, he cannot be assessed on the difference between the par and market values, because the mere exercise of the option does not result in realisation of profit in the commercial sense. [64]

The forms which money's worth or the equivalent of cash may assume are beyond enumeration. Realisation of income in money's worth may arise from transfer of immovable property such as a colliery [65] or lands [66] by a debtor in satisfaction of a debt. In *John Emery v IR,* [67] the assessees were speculative builders who bought lands and built houses thereon. They created ground annuals or rent charges which meant that the annual rent was a burden upon and realisable out of the land but was not a personal obligation upon the purchaser. The assessees disposed of their entire interest in the land and house for cash, reserving to themselves the rent charges. The House of Lords held that the rent charge was a marketable security and its capitalised value should be brought into account in computing profits. [68]

Likewise, income would be realised in case of issue of saleable government bonds for the total amount of principal and interest under a statutory provision for the relief of debtors, [69] or transference of movables such as jewellery, or of a decree of a court of law, [70] or promissory notes or bills of exchange of third parties [71] or a debt due to the debtor from a third party. [72] (As regards cheques, promissory notes or other securities of the debtor himself, see under 'Debtor's promise to pay at future date: Payment by cheque'.)

Where the assessee is liable to pay outgoings, charges and maintenance expenses in respect of a certain house and under another's will the payments are made on behalf of the assessee by the trustees of the will, the amount so disbursed by the trustees is taxable as the income of the assessee just as an allowance in cash would be. [73] However, if a religious institution discharges its legal obligation to defray the household expenses of the *acharya* (the spiritual head), the value of the benefit derived by him cannot be taxed as income in money's worth. [74]

22. Realisation of Income by Exchange or Conversion of Securities. --When shares, stocks or securities are exchanged under a scheme of amalgamation or conversion, the transaction is the equivalent of realisation and reinvestment, irrespective of whether the transaction was effected voluntarily or under legal obligation. As soon as new securities are taken in place of the original securities, the original investment comes to an end and a new venture begins. As Lord Buckmaster observed in *Westminster Bank Ltd. v Osler,* [75] 'The fact that this transformation took place by the process of exchange does notavoid the conclusion that there has been what is described as a realisation of the security'. Consequently, the assessee would be assessable on any revenue profit deemed to have been made by him on such exchange or conversion. [76]

In *Westminster Bank Ltd. v Osler,* [77] the bank held national war bonds which by the terms of issue were convertible into war loan. Thereafter, the Treasury made an offer to the holders giving them the option to surrender their bonds in exchange for conversion loan. In response to that offer, the bank surrendered a part of its holdings in exchange for conversion loan, and in exercise of its rights under the original issue converted its remaining holdings into war loan. In both cases, the transaction was profitable to the bank. The House of Lords held that the original holdings had been realised and the difference between the value of the new stocks and the cost of the original investment must be brought into account as assessable profits.

Where an insurance company effected an exchange of securities in pursuance of a railway amalgamation scheme, and the new stocks received in place of the surrendered stocks had a definite market value which was less than the original cost to the company of the surrendered stocks, the company was allowed to deduct the difference as a loss. The arrangement amounted in effect to a realisation of the old stocks and a reinvestment in new stocks. A new starting point was set up, so that there would be a new profit or loss on the substituted stocks and such a new starting point must be a final point for the old investments. [78] Where a dealer of shares exchanges shares of one company held by him as stock-in-trade for the shares of another company, the difference between the book value of the original shares and the market value of the shares of the other company as on the date of exchange is assessable as his business income. [79]

23. Valuation of Money's Worth. --Where realisation consists in money's worth, the market value of the money's worth in the accounting year must be ascertained and brought into computation for the purpose of determining the year's profits. [80] Thus, the value of ground annuals or rent charges was capitalised at 20 or 22 years' purchase in *Ruskin Inv Ltd. v Copeman* , [81] having regard to the rates of yield prevailing at the relevant time. Where goods presented by an employer are taxed as a perquisite in the hands of the employee, the value to be taxed is not their cost to the employer but their value to the employee, *i.e.* the price the employee would get if he sold them second hand. [82] Similarly, as stated above, directors or employees of a company would be assessable on shares issued to them at par to the extent of the premium value of the shares in the market at the date of issue, [83] subject to abatement where a restriction is imposed on alienation. [84] However, an option to an employee to subscribe for shares at a specified price at any time during a fixed period of years must be valued as the income of the year in which the option is granted . [85] Viscount Simon said in *Gold Coast Selection Trust Ltd. v Humphrey* : [86]

If the asset takes the form of fully paid shares, the valuation will take into account not only the terms of the

> agreement but a number of other factors, such as prospective yield, marketability, the general outlook for the type of business of the company which has allotted the shares, the result of a contemporary prospectus offering similar shares for subscription, the capital position of the company, and so forth. There may also be an element of value in the fact that the holding of the shares gives control of the company. If the asset is difficult to value, but is nonetheless of a money value, the best valuation possible must be made. Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible.

When a moneylender takes land in satisfaction of his debt, the market value of the land would have to be ascertained and brought into account, and to the extent to which the market value exceeds the principal sum advanced there would be a realisation of interest. [87] Unless the land is sold by the assessee in the same year, the actual value of the land cannot be ascertained, but an estimate of its value must be made. As Lord Lorebum LC observed in *Sun Ins. Office v Clark*, [88] 'A rule of thumb may be very desirable, but cannot be substituted for the only rule of law that I know of, *viz* : that the true gains are to be ascertained as nearly as it can be done'. Where the figure at which the lands were entered in the assessee's books was merely an arbitrary and fictitious figure and bore no relation to the real value of the lands, the assessee was held not bound by the figure. [89] However, if the assessee enters the acquisition of the land as equivalent to the receipt of a certain amount in the profit and loss account or does anything else definitely recognising the land as being the equivalent of a certain amount of money for purposes of calculating his profits, the income-tax authorities may be justified in taking the value placed upon the property by the assessee himself, as *prima facie* the true value. [1] Though in such a case the assessee may be bound by his own valuation in his books of account, the department is in no case bound to accept the assessee's figure and is free to fix its own estimate of the value. [2] If the assessee has not made any valuation, it would be open to the department to estimate the real value. [3] Inasmuch as such a valuation would necessarily be based upon a mere estimate, an adjustment may be made in a subsequent year in which the land is actually sold. [4]

Where a property is purchased by a mortgagee in execution of a mortgage decree against a debtor, the value of the property has to be ascertained, for there is a realisation of interest to the extent to which the value of the property exceeds the original principal sum due. [5] The price which the assessee bids at the public sale may ordinarily be taken to be the value of the property. [6] But it is open to the taxing authorities to hold that the property was worth more or less than the price which the assessee bid for it. In order, however, to hold that the property is worth more than the price fetched at the public sale, the taxing authorities must have in their possession some tangible evidence. There is no onus on the assessee to prove that the property is not worth more. [7] (See also under **s 145** , 'Profits of trade in land and buildings' and 'Opening value of stock-in-trade: Cost of acquisition'.)

24. Debtor's Promise to Pay at Future Date: Payment by Cheque. --A creditor may realise his debt by accepting a promissory note of a third party to pay, but when the debtor gives his own promise to pay at a future date there is no realisation. *CIT v Kameshwar Singh* , [8] establishes that a debtor who gives his creditor a promissory note for the sum he owes can in no sense be said to pay his creditor; he merely gives a document or voucher of debt possessing certain legal attributes. However, when the debtor's cheque (not postdated) is accepted by the creditor, the cheque is the equivalent of cash payment, and income would be received or realised at the time and place at which the cheque is accepted. (See under **s 5(1)(a)** , 'Actual and constructive receipt', and 'When and where is income received'.)

In *Cross v London & Provincial Trust Ltd* ., [9] a company held bearer bonds of a foreign country. The government of that country suspended interest payment but offered bondholders, in exchange for their interest coupons, twenty-year funding bonds carrying five per cent interest. The company exchanged their coupons for the funding bonds which they then sold. It was held by the court of appeal that the issue of the funding bonds was not a payment of an equivalent of interest or a payment of interest in kind and the value of the funding bonds at the date of issue could not be regarded as realisation by the company of interest. The tree had produced

no fruit, to use a well-worn simile, and the fact that the debtor's fresh promise to pay took the form of a marketable instrument was irrelevant. [10] The funding bonds were money's worth but that did not necessarily make them income. As Greene MR observed, 'It is one thing to say that income is nonetheless income because it is received in the shape of money's worth instead of money--this proposition is true; it is a totally different thing to say that the receipt of money's worth is necessarily a receipt of income-this proposition is not true'. [11] It was further held that the company did not realise any interest or income even when it sold the funding bonds. 'If the debtor cannot be said to have paid his creditor by giving him his promissory note, equally(the creditor) does not receive payment, or acquire income, when he sells the promissory note for what it will fetch'. [12] The latter part of the decision is, incorrect, and in any event would not apply under this Act. A creditor does not realise any interest or principal when he takes a promissory note from his debtor, but when the creditor assigns it for value, the value received may amount to realisation of income and the date of realisation of income would be the date of receipt of value on assignment.

(a) When Debtor gives Security.--Similarly, where a debtor, unable to pay on the due date, executes a mortgage by way of security, there is no realisation of income. [13] To give security for a debt is not to pay a debt. [14] In the Privy Council case of *Raghunandan Prasad v CIT,* [15] the assessees who were holders of a mortgage on which the interest was in arrear accepted in discharge of that mortgage and all sums due thereunder, a new mortgage for a principal sum which included arrears of interest due under the old mortgage. The grantors of the new mortgage were not identical with the grantor of the old mortgage and the property mortgaged was greater in extent than that covered by the old mortgage. The accounts were maintained on cash basis. The Privy Council held that the assessees merely received further and better security for an existing debt and that the substitution effected could not in any real sense be described as realisation or equivalent of payment of the principal and interest of the original mortgage. This decision was applied by the House of Lords in *IR v Oswald,* [16] and was followed by the Privy Council in *CIT v Kamakshya Narain Singh.* [17] These cases must, as noted above, be distinguished from the case where a security of a third party, which is readily saleable, is given in satisfaction of a debt and amounts to realisation of income, for example where government bonds which are transferable are issued under a statute in lieu of interest due from a private debtor. [18]

(b) Capitalisation of Interest.--Capitalisation of arrears of interest is not equivalent to receipt of interest by the creditor. It is immaterial whether capitalisation takes place by virtue of a provision in the original contract for the automatic conversion of unpaid interest into principal money carrying interest, or the optional exercise of a power in that behalf given to the creditor, [19] or a customary practice of banks. [20] The effect of an agreement to capitalise arrears of interest is merely to pay compound interest. However, 'the unpaid interest never ceases to retain its character as interest, although it has from time to time been added to the capital indebtedness and has carried interest in turn.' When the whole capital, including the capitalised interest, is paid off, whatever is paid over and above the original capital sum advanced is for revenue purposes a payment of interest. [21]

(c) Importance of System of Accounting.--If the assessee chooses to treat the interest due under the original loan as having been received and paid on the debtor's executing a fresh promissory note capitalising the arrears of interest, and the interest is entered as having been received both in the interest account and in the personal account of the debtor, interest under the original loan will be deemed to have been realised. [22] On the other hand, it would be open to the assessee to prevent assessment of such interest by so adjusting his accounts as to make it clear that the fresh promissory note is not taken as effecting payment of the interest due under the old loan. [23] It depends upon the method of accounting whether the interest is chargeable when it accrues or when it is paid. [24] If accounts are maintained on mercantile basis, interest would be taxable even where it is merely capitalised or the debtor has only entered into a further undertaking to pay, for under the mercantile system income is taxable when it accrues and not when it is received or realised. On the other hand, under the cash system of accounting, income attracts tax only when it is received. **Section 145** provides that income, profits and gains should be computed, for the purposes of **s 28** (business, profession or vocation) or **s 56** (other sources) in accordance with the method of accounting regularly employed by the assessee. Thus, **s 145** gives

the assessee the option to determine whether he should be taxed on the accrual basis or on the receipt basis. However, limited companies are compelled by **s 209** of the **Companies Act** 1956 (the Companies Act) to maintain their accounts on accrual basis.* (See further under **s 5(1)(a)** , 'Receipt is not sole test of taxability'.)

25. Appropriation as between Capital and Interest. --Where interest is outstanding on a principal sum which has become due and the creditor receives an open payment from the debtor, the creditor is at liberty to appropriate the payment towards principal. [25] However, if neither the debtor nor the creditor makes any appropriation of the payment as between capital and interest, the department is entitled to treat the payment as applicable to the outstanding interest and assess it as income. [26] Where, however, there is no cash payment but an arrangement is arrived at affecting the whole indebtedness, whereby the creditor accepts certain assets in part satisfaction and takes the debtor's promissory notes for the balance, the basis of the presumption, *viz.,* that it is to the creditor's advantage to attribute payments to interest in the first place (leaving the interest-bearing capital outstanding), is gone. In such a case, the assessee is entitled up to the last moment to appropriate the assets in discharge *pro tanto* of the debtor's capital liability. [27] In a question with the revenue the tax-payer is entitled to appropriate payments as between capital and interest in the manner least disadvantageous to himself. [28] However, if the debtor has paid, and the creditor has accepted, a sum as interest, then no book-keeping can alter the nature of that payment or affect the liability to tax. [29]

26. Application of Income and its Diversion by Overriding Title. --Cases arise where income is applied in a particular manner under a statutory or contractual obligation or under the provisions of a company's memorandum or articles of association. Such appropriation or destination of profits, or the charge which has been made on them by previous agreement or otherwise, is perfectly immaterial and has nothing to do *prima facie* with the question whether they are liable to income-tax. [30] If a person has alienated or assigned the source of his income so that it is no longer his, he may not be taxed upon the income arising after the assignment of the source, [31] apart from special statutory provisions like ss 61 to 64 which artificially deem it to be the assignor's income. However, if he does not transfer the source of income and merely applies the income so that it passes through him and goes on to an ultimate purpose, even though he may have entered into a legal obligation to apply it in that way, still it remains his income. Thus, if dividends [32] or royalty [33] or share of profits in a firm [34] are settled upon trust, while the capital assets, *viz.,* the shareholding or the leased assets or the partner's interest in the firm, remain the property of the settlor, the case would be one of mere application of income. This principle has been given statutory effect by **s 60** .

The purpose of application of income is immaterial. [35] Application to charitable objects does not affect liability to taxation. [36] Thus, where an advocate received professional fees on an express understanding which created no legal obligation, that he would settle them upon a charitable trust, the Supreme Court held in *CIT v Thakardas Bhargava,* [37] that it was merely a case of application of income. Setting aside of income for a specified purpose, even under a legal obligation, was held to be a case of mere application of income. [38] On the other hand, if a businessman recovers an extra amount from his customers specifically for charity and is obliged by contract or custom to utilise it for charitable purposes only, the amount is received by him as a trustee for charity and cannot be taxed as his income. [39] But amounts of licence fees, fines, etc. collected by the assessee - a race club - and credited to the benevolent fund created by it, were held to form part of the income of the assessee as the diversion of income took place after, and not before, such amounts had reached the assessee. The contributions were made voluntarily and not under any statutory compulsion, application of such amounts for a benevolent purpose could not be regarded as diversion by overriding title. [40] But, on facts, a contrary view had been earlier taken in a case where the amounts credited to the benevolent fund were not part of the income of the Bangalore Turf Club. [41] Similarly, upon an assignment of right, title and interest in a portion of the income in favour of a charitable trust, the assessee is not taxable on that income. [42] **Section 80G** grants relief from tax in respect of amounts donated to certain charitable institutions and funds.

In *Pondicherry Rly Co. Ltd. v CIT,* [43] a company was bound by contract to pay half its net profits to the French government. It was held by the Privy Council to be liable to tax on the money so paid over to the

government. Lord Macmillan said, 'Profits on their coming into existence attract tax at that point and the revenue is not concerned with the subsequent application of the profits'. [44] An incorporated society of composers, authors and publishers of copyrighted musical works, which received royalty for the grant of performing rights and which could utilise this royalty for certain purposes and distribut the balance among the members in proportion to the member's work publicly performed, was held assessable in respect of the royalty. [45] Similarly, a company is liable to tax on the income which is applied in creating a reserve fund under **s 205(2A)** of the Companies Act, [46] or in the formation of a sinking fund in pursuance of a contractual or other legal obligations [47] or applied in paying guaranteed interest to the holders of shares or debentures. [48] So also, having regard to the provisions of the **Electricity (Supply) Act** 1948, the amounts which an electricity company is obliged to credit under that law to contingencies reserve, [49] amounts transferred to a statutory reserve fund **,** [50] and to tariffs and dividends control reserve [51] or development reserve [52] have been held to constitute application of income. However, where an electricity company is statutorily entitled to profits only up to a prescribed limit and enjoined to return the excess to the consumers at a future date by way of consumers' rebate reserve, [53] or where the government pays to a company guaranteed interest which does not form part of the general revenue of the company at all but is expressly earmarked for the debenture holders, [54] such excess or interest cannot be said to be the income of the company. So also the amount credited by a State Road Transport Corporation to an insurance fund under binding rules [55] and the amount transferred by a co-operative society to a reserve fund as required by law [56] have been held to constitute diversion of income by overriding obligation. Similarly, creation of reserves under the Molasses Control Order has also been held to be diversion of income by overriding title by the Madras, [57] Karnataka [58] and Madhya Pradesh [59] High Courts. Likewise, the Bombay High Court held that amounts credited to an account as required by Ethyl Alcohol Order [60] and to area development fund, cane development fund, hutments fund, relief fund, savings fund and a memorial fund under statutory governmental directions [61] were all diverted at source by overriding title. Profits paid by the assessee to state government under an agreement with it to run a dairy project was held by the Gujarat High Court to be diversion of profits by an overriding contractual obligation. [62] The principle of *Pondicherry Rly* case is further explained in the light of subsequent case law under **s 37** , (under 'Wholly and exclusively for the purposes of the business'), and 'Payments out of profits and payments ascertained by reference to profits'.

The Molasses Control Amendment Order required a separate Molasses Storage Fund to be created. A portion of the sale proceeds of molasses had to be credited to this fund and could not be utilized for any other purpose except for construction of storage tanks in accordance with the guidelines prescribed. The amount required to be statutorily set apart could not be treated as income as the said amount was diverted by overriding title to a separate statutory fund. This view was taken by several High Courts [63] and affirmed by the Supreme Court. [64] It has also been held that contribution to the Molasses Storage Fund is allowable as a revenue expenditure under **s 37** . [65]

The amount carried forward by the assessee for being set on in succeeding years for payment of bonus to employees as enjoined by the **Payment of Bonus Act** 1965 is not diverted by an overriding title. [66] Where a town council carried on a gas undertaking and an electricity undertaking, and, in order to reduce the accrued deficiency on the electricity revenue account, it transferred year after year, as authorised by statute, certain sums out of the revenues of the gas undertaking to the credit of the electricity department, it was held that the sum so transferred could not be deducted in computing the profits of the gas undertaking, for it was merely a case of application of income. [67] Similarly, the amount appropriated to the 'government share capital redemption fund' which continued to belong to the assessee and was not diverted to anybody else was held not to be not deductible. [68]

Salaries are taxable although for some reason or another the recipient may not have the full right to apply them just as he likes. [69] Compulsory deductions from remuneration by the employer are instances of mere application of income, and the full salary is taxable without any allowance for the compulsory deductions. [70] The fact that the recipient of emoluments has made them over to another person does not render the former any

the less assessable to tax. [71] Sums set aside by a man for the benefit of his family out of his income in pursuance of a covenant in his marriage settlement or out of his salary under a compulsory provision contained in the agreement of employment, [72] or paid to his ex-wife under an agreement with the employer [73] are still his income. Similarly, an assessee is not entitled to any deduction in respect of maintenance paid by him to his wife and children under a decree of court, [74] unless the decree makes the maintenance a charge on the assessee's property or income. [75]

Income applied in liquidation of a voluntarily incurred debt is exigible to tax although the application may be under a legally binding covenant entered into by the recipient of the income [76] or under a charge created by the debtor on his property. [77] An exception is provided by **s 24(1)(iv)** under which an annual charge is deductible in computing income from house property; but from the assessment year 1969-70 onwards such deduction is not permissible if the charge is created voluntarily. In *IR v Paterson,* [78] a wife, in order to render her husband financial assistance, obtained a loan from an insurance company and deposited certain shares with the company as security for the loan. She further gave the right to the company to receive the dividends on the shares and apply them in paying interest on the loan and in discharge of the principal. The court of appeal held that the dividends were her own income and she was liable to tax thereon. If they were not her income they could only be the income of the creditor company and a creditor could not be thought of as discharging debts due to him out of his own income. [79] Similarly, where a wife bound herself to pay a certain part of her income to the trustees of her marriage settlement in repayment of an advance obtained by her husband from the trust funds, the income so applied was held chargeable in the hands of the wife. [80] So also, payment of interest in respect of amounts due to unsecured creditors under an arbitrator's award is application of income. [81]

Just as a man's income does not cease to be his income merely because it is applied in payment of his debts, so the money of another person applied in paying the assessee's debts is not necessarily the assessee's income. In *IR v Wemyss* [82] the assessee assigned to the trustees of his marriage settlement certain shares on trust to pay the income to himself for life, but in the event of the yield exceeding the rate of 12.5 per cent in any year, the trustees were to retain such excess income and apply it from time to time in reducing two charges on the trust funds created by the assessee as security for his personal debts. Held, the income from the shares in excess of 12.5 per cent per annum could not be included in the assessee's income. He derived a direct advantage from the income in question being applied in paying his personal debt, but the income so applied was not his income but that of his marriage settlement trustees. Here, the interests of third parties (*viz* the wife and children) intervened. He had debarred himself from any voice in the disposal of the income which never became his, though he benefited by the provision for its application. Under the present Act, the income would be taxable in his hands in view of ss 61 and 63.

In *Stocker v IR,* [83] two partners who were brothers were bequeathed a life-interest in a business, with remainders over, the sons being entitled if they entered into partnership to have the business estate handed over to them for the purposes of carrying on the business. To preserve the assets of the business for the remaindermen, the partners entered into a covenant to set aside a certain percentage of the net profits of the business so as to build up a reserve fund to meet any losses arising out of the business. Subject to this condition for the benefit of the remainder men, the reserve fund remained the property of the partners. Rowlatt J held that sums thus set aside could not be included in the income of the partners. The correctness of this decision is open to doubt, since no obligation to create the sinking fund was imposed by the father's will and subject to one condition the sinking fund still remained the property of the partners.

Where executors having received the whole of the income of the estate apply a portion in a particular way pursuant to the directions of the testator or other legal obligation, it is merely a case of application of income. Payment of *addya sradh* expenses, the costs of probate, death duties and other debts due to the State, [84] or periodic payments to beneficiaries out of the income of the estate [85] in compliance with the obligatory directions of the testator, cannot be excluded in computing the chargeable income of the estate. Nor can 'lunacy percentage' payable under a statute to the Crown on the income of a lunatic's estate managed by the court, be

excluded in computing the income of the lunatic. [86]

(See also under **s 15** , 'Application of salary', and under **s 56(2)** , 'Application of dividend'.)

Diversion by Overriding Title.--Though a voluntary payment is included in the income of the payer, where an obligatory charge is imposed by a testator or by the law upon some property, or such charge is otherwise involuntarily created, the sum so charged must be excluded from the income of the person in enjoyment of the property. [87] In other words, where income is not applied but 'diverted by an overriding title' from the assessee who would otherwise have received it, it cannot be considered the income of the assessee at all. [88] Where the obligation effectively slices away a part of the corpus of the right of the assessee to receive the entire income, it would be a case of diversion of income. [89] As the Supreme Court has explained, the doctrine of diversion of income by reason of an overriding title applies when, by reason of an overriding title or obligation, income is diverted and never reaches the person in whose hands it is sought to be assessed; the profit earned by him was not really his profit but it belonged to somebody else and the assessee had no title to it. [90]

The Supreme Court in *Dalmia v CIT,* [91] held that where the assessee company, the owner of two cement factories situated in Pakistan, agreed to sell and transfer them under an agreement whereunder the profits and loss arising from the operations were to be on account of the purchaser during the specified period, the profits were diverted to the purchaser in terms of the agreement and were not taxable in the hands of the assessee company.

In *Bejoy Singh Dudhuria v CIT,* [92] the assessee succeeded to the family ancestral estate on his father's death. Subsequently, his step-mother who had a legal right to maintenance out of the estate, brought a suit for maintenance against him in which a consent decree was passed directing the assessee to pay a fixed monthly sum to his step-mother and declaring that the maintenance was a charge on the ancestral estate. It was conceded that the assessee was liable to be assessed as an individual and that he and his step-mother were not members of an undivided family. The Privy Council held that the sums paid by the assessee to his step-mother were not 'income' of the assessee at all. Lord Macmillan, delivering the judgement said, 'In the present case the decree of the court by charging the appellant's whole resources with a specific payment to his step-mother has to that extent diverted his income from him and has directed it to his step-mother; to that extent what he receives for her is not his income. It is not a case of the application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out of his revenue before it becomes income in his hands.' [93] Where a decree of court declared that a certain property belonged to the assessee as the residuary legatee subject to certain payments for maintenance to members of the family [1] or that an impartible estate belonged to the assessee as the heir subject to a charge for maintenance due to two widows of the previous holder, [2] or where under an arbitration award, or under a decree in terms of an arbitration award, two widows were to be given maintenance allowance in lieu of their share on partition in the family property which was awarded to the assessee, [3] the sums paid by way of maintenance were excluded from the income of the assessee since they amounted to diversion of a portion of the income before it reached his hands. Similarly, where sums were paid by a partnership firm under a legal obligation to a retired partner, [4] or to a trust [5] or a sub-partnership [6] set up by a partner, or to specified heirs or relations of a deceased partner, [7] the sums were excluded from the taxable income of the firm applying the doctrine of diversion of income. It has been held that such diversion of income by an overriding title need not necessarily be by a decree of court or by statutory or customary law, [8] but may be under an attachment order of an income tax authority, [9] or under the provisions of a will, [10] or agreement, [11] or deed [12] like a deed of sale [13] or gift [14] or partnership [15] or sub-partnership [16] or partition of joint family property. [17] Where the beneficiaries under a settlement pay a maintenance allowance to the settlor's widow who is entitled under the terms of the settlement to maintenance for life, [18] or where legatees are bequeathed a property with a direction to pay annuities or other sums out of the income of the property to members of the family, [19] the payments constitute diversion and not application of income. In all such cases the amount paid by way of maintenance would be taxable in the recipient's hands though not in the hands of the payer. [20] However, where the assessee inherits properties which had been pledged to secure overdraft, the income from the

properties, to the extent of the interest paid to the bank is not diverted by an overriding title. [21]

Where another is entitled to maintenance out of a non-coparcenary property, for instance, an impartible estate holder's brother being entitled to maintenance out of the estate, there is a diversion of income and the amount should be deducted in calculating the assessable income of the estate holder. [22]

In *CIT v Patuck,* [23] the Bombay High Court, reviewing the case law, held that a allowance paid to a wife or child in pursuance of a decree of court in a matrimonial suit where the decree makes the allowance a charge on the property or income of the assessee must be treated as income diverted by an overriding title. Similarly, where the assessee received under a will a right to income from certain properties, the assignment of such right by the assessee to his children was held to be a diversion of income. [24] On the other hand, where such maintenance is decreed without any charge being created on the property or income of the assessee, it would represent mere application of income, [25] as would an allowance agreed to be given by a man to his wife, child or aged parent whom he is under a personal obligation to maintain. [26] (See further under **s 37** , 'Payments out of profits and payments ascertained by reference to profits'.)

Capital and Income

While all revenue receipts are assessable under the Act unless specifically exempt, a capital receipt may or may not be so chargeable to tax. A capital receipt would be chargeable to tax where it falls for consideration under **s 45** of the Act, subject to the other relevant statutory provisions.

The problem of discriminating between capital receipts and income receipts, and between capital disbursements and income disbursements, has very frequently engaged the attention of the courts. In general, the distinction is well recognised and easily applied, but from time to time cases arise where the item lies on the borderline and the task of assigning it to income or capital becomes one of much refinement. As the Act does not define income except by way of adding artificial categories, it is to the decided cases that one must go in search of light. While each case is found to turn upon its own facts and no infallible criterion emerges, nevertheless the decisions are useful as illustrations and as affording indications of the kind of considerations which may relevantly be borne in mind in approaching the problem. [27] (See also under **s 37** , 'Capital expenditure and revenue expenditure'.)

27. Disintegration of Single Sum into Capital and Income. --Where a single amount received by the assessee is partly on capital account and partly on income account, it should be apportioned and the part which is of a revenue nature should be brought to charge. [28]

28. Immaterial Considerations. --There are some considerations which are immaterial in deciding the question whether a certain item is a capital receipt or an income receipt:

(a) Payment Measured by Estimated Profits.--The fact that a certain payment is measured (as is usually done in computing damages) by the estimated annual yield or profits, does not make the payment an income receipt. [29] 'There is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test'. [30]

(b) Lump Sum and Periodic Sums.--That the receipt is a periodic receipt or a single receipt is immaterial for the purpose of determining its nature. [31] 'There is no magicin the distinction between a lump sum and a periodical sum'. [32] An income receipt is not necessarily recurring, nor a capital receipt necessarily single. A single or an occasional receipt may be an item of income [33] and an annual receipt recurring over a number of years may be capital. [34]

(c) Magnitude of Receipt.--The magnitude of a sum is not material for the purpose of determining its nature, [35] for magnitude is a relative term. However, at the same time the magnitude of a transaction is not an

entirely irrelevant consideration. [36]

(d) Name given by Parties Concerned and Treatment in Accounts.--As Viscount Simon observed in *IR v Wesleyan & General Assce Society,* [37] 'The name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction. To call a payment a loan if it is really an annuity does not assist the taxpayer any more than to call an item a capital payment would prevent it from being regarded as an income payment if that is its true nature. The question always is what is the real character of the payment, not what the parties call it'. [38] An amount that was shown as surplus in the profit and loss account but which had not been received, would not constitute income. [39] Likewise, the way in which the receipt is dealt with in the accounts of the assessee is not conclusive against or in favour of the assessee. [40] As the Supreme Court observed in *Tuticorin Alkali v CIT,* [41] 'whether a receipt of money is taxable or nothas to be decided according to the principles of law, and not in accordance with accountancy practice'.

(e) Accounting Treatment not Conclusive.--If a receipt is a trading receipt, the fact that it is not so shown in the book would not prevent the assessing authority from treating it as a trading receipt. It is the true nature and quality of the receipt and not the manner in which it is entered in the accounting book that is decisive. [42] Thus, amounts collected by a seller of country liquor from a wholesale dealer was treated as a security deposit and credited to a deposit account. The deposit was returned when the bottles were returned. It was held that the net amount that remained after refunding the portion on return of bottles would be a trading receipt and liable to tax. The fact that the amount was entered in a separate ledger under the heading 'empty bottles returned deposit account' did not alter the real nature of the receipt. [43]

(f) Form of Transaction.--If the transaction, on its true construction, escapes tax as being on capital account, it is immaterial that the same result could be brought about by a transaction in another form which would yield taxable income. [44] (See further under **s 1** , 'Disposition of property so as not to attract tax: Form and substance.)

(g) Income from Wasting Assets.--It is well settled since the decision of the House of Lords in *Coltness Iron Co. v Black,* [45] that profits from capital which is consumed and exhausted in the process of realisation may nonetheless be taxable as income. Thus income derived from mines and quarries, [46] nitrate grounds, [47] timber-bearing forests, [48] or annuities, [49] is not realisation of capital, but is taxable as income regardless of the consumption of capital involved in the process of profit earning. Lord Wright said in *Kamakshya Narain Singh v CIT,* [50] 'If the receipts are income, it is not material for tax purposes that that for which they are paid comes from a wasting property. If the payment ceases because the source ceases, so does the tax. Once it is established that the royalties are income within the meaning of the Act it is not material that the mines are in course of being exhausted unless it is provided in the Act that there should be a deduction from the income on that particular ground.' (See also under **s 29** , 'No allowance in respect of exhaustion of capital or wasting assets'.)

(h) Payments made out of Capital.--The nature of a receipt is determined entirely by its character in the hands of the receiver, and the source from which the payment is made has no bearing on the question. Where an amount is paid which, so far as the payer is concerned, is paid wholly or partly out of capital, and the receiver receives it as income on his part, the entire receipt is taxable in the hands of the receiver. [51] This would be so where a trustee pays an annuity to a beneficiary wholly out of the corpus, or partly out of the corpus or from borrowed capital to make up for deficiency of income of the estate. [52] However, if the recipient is beneficially entitled not only to the income but also to the capital, payments made to him by his trustees out of the corpus would be capital receipts. [53] The intention of the settlor or testator that the amount should be treated as capital in the hands of the beneficiary is immaterial for the purpose of determining the nature of the beneficial receipt. [54]

(i) Disallowance to Payer.--The fact that the payment is not allowed as a revenue deduction to the person making it, does not lead to the conclusion that it is a capital receipt in the hands of the recipients: [55] The

character of the receipt needs to be examined in the hands of the receiver. [56]

Tests to Distinguish between Capital and Income Receipts

The following criteria are usually invoked in distinguishing between capital receipts and income receipts:

29. Fixed Capital and Circulating Capital. --A receipt is not taxable when it is referable to fixed capital; it is taxable as a revenue item when it is referable to circulating capital or stock-in-trade. [57] In *John Smith v Moore,* [58] Lord Haldane quoted with approval the distinction drawn by Adam Smith between fixed and circulating capital: 'Fixed capital (is) what the owner turns to profit by keeping it in his own possession; circulating capital (is) what he makes profit of by parting with it and letting it change masters'. [59] In other words, circulating capital is capital which is turned over, and in the process of being turned over yields profit or loss. Fixed capital is not involved directly in that process and remains unaffected by it. [60] Circulating capital or stock-in-trade is also known as 'trading assets' and fixed capital as 'capital assets'. [61] What is a capital asset in the hands of one person may be a trading asset in the hands of another, and the nature of a receipt may consequently vary according to the nature of the trade in connection with which it arises. In *Golden Horse Shoe (New) Ltd. v Thurgood,* [62] Romer LJ said:

> The determining factor must be the nature of the trade in which the asset is employed. The land upon which a manufacturer carries on his business is part of his fixed capital. The land with which a dealer in real estate carries on his business is part of his circulating capital. The machinery with which a manufacturer makes the articles that he sells is part of his fixed capital. The machinery that a dealer in machinery buys and sells is part of his circulating capital, as is the coal that a coal merchant buys and sells in the course of his trade. So, too, is the coal that a manufacturer of gas buys and from which he extracts his gas. [63]

The purchase and re-sale of amusement equipment would be on revenue account in the case of an amusement caterer. [64]

In *CIT v Ram Kumar Aggarwal,* [65] the Supreme Court held that when shares of a company are held as stock-in-trade, the surplus received on liquidation of the company would be a revenue receipt; if the shares are held by way of investment, the money so received would be a capital receipt. Reimbursement of a capital outlay is a receipt on capital account, [66] even though the receipt may exceed the cost of the outlay. [67] Similarly compensation received for the immobilisation, sterilisation, destruction or loss, total or partial, of a capital asset is a capital receipt, [68] whereas compensation for injurious affection of a trading asset is an income receipt. [69]

It may be broadly stated, as observed by the Supreme Court in *Oberoi Hotels v CIT,* [70] that what is received for loss of capital is a capital receipt; what is received as profit in a trading transaction is taxable income.

Illustrations

1. A company which carried on business as manufacturer of fireclay goods was the lessee of certain fireclay fields over a part of which ran the lines of a railway. In the exercise of its statutory powers, the railway company required the part of the fireclay which was under the railway to be left unworked on payment of compensation. The compensation was held to be a capital receipt, being payment made for the immobilisation or sterilisation of the fireclay deposits which were a

capital asset. The fact that the amount of compensation was computed on the basis of the profits which would have been earned by working the fireclay did not make it an income receipt. [71] If the compensation had been recovered for wrongful interference for a period of time with the working of a particular part of the field, the compensation would have been an income receipt because the damage would have been to the trade in fireclay goods during the period of wrongful interference and not to the clayfield as a capital asset. [72]

2. A company doing the business of building contractors and estate developers was refused permission to build houses on a certain plot by the local authorities and was paid compensation as required by statute. Held, in the trade of building houses for sale the lands and the right to build thereon were trading assets or stock-in-trade, and the compensation being for the injurious affection of trading assets must be regarded as a trading receipt. [73]
3. The assessee, which had installed machinery for the generation of electricity and had laid mains and distributing lines for supplying it to consumers, charged contributions at certain rates from the consumers for the laying of service lines from its distributing mains to the consumers' premises. The assessee received as contributions from the consumers a sum which exceeded the actual cost of laying the service lines. The Supreme Court held that the contributions by the consumers, being essentially reimbursement of capital expenditure, were not income, and even the excess of the contributions over the actual cost was a capital receipt in the hands of the assessee.

However, the principle that a receipt is not taxable when it is referable to fixed capital is not of universal application. A capital asset may be transmuted into income and the 'price' realised on its sale may take the form of periodic revenue payments. (See post under 'Annuities and annual instalments of capital', and cf under **s 37** , under 'Capital expenditure and revenue expenditure', 'Fixed capital and circulating capital: Annual payments unrelated to any fixed sum'.)

30. Capital Sales and Business Sales. --Where profit accrues from the sale of any asset, the question arises whether it is business income or capital gains. Where the property sold is a capital investment or a capital asset, there is an accretion of capital, for the proceeds of sale represent capital in another form; where, on the other hand, the sale is in course of business, the profit is on revenue account. [74] The distinction between capital accretion and income is 'sanctified by the usage now of a century'. [75] In *Thew v South West Africa Co. Ltd.,* [76] Rowlatt J stated the question simply and decisively: 'Is the article acquired for the purpose of trade?' If it is, the profits arising from its sale must be brought into revenue account. The profit is chargeable as capital gains under **s 45** if the sale is of a capital asset, and as business profit under **s 28** if the sale is in the course of business or the transaction constitutes an adventure in the nature of trade.

The line between 'capital sales and sales producing income', to use the phrase of Lord Phillimore, [77] is correctly drawn by Lord Justice Clerk in *Californian Copper Syndicate v Harris,* [78] in a passage which has become classical:

> It is quite a well settled principle in dealing with questions of assessment of income-tax that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not profit assessable to income tax. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be so assessable where what is done is not merely a realisation or change of investment, but an act done in what is truly the carrying on, or carrying out, of a businesswhat is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its facts; the question to be determined being--Is the sum of gain that has been made a mere enhancement of value by realising a security or is it a gain made in an operation of business in carrying out a scheme for profit-making? [79]

In the absence of any evidence of trading activity in cases of purchase and re-sale of shares, [80] gold, [81] silver, [82] and land and buildings, [83] the court reversed the finding of the tribunal and held the profit arising from the re-sale to be an accretion of capital. On a finding that the assessee did not carry on any trading activity in relation to the disposal of slag heaps, the sales of slag heaps were held to be on capital account. [84] Where the assessee sold a brick kiln, which was held as a capital asset, the loss from such sale would automatically be considered a capital loss. [85] Where the assessee was admittedly not trading in money transactions, a grant of a loan from a bank cannot be characterized as a trading transaction. [86] Conversely, where the assessee made profits from selling silver articles that were used as raw materials in his business, such profits can only be taxed as revenue. [87] On the other hand, where the purchase and sale of mining rights, [88] brine bath, [89] ships, [90] or wagons [91] were in the course of the assessee's trade and in pursuance of his scheme of profit-making, the transactions were held to result in trading profits.

The surplus received from the sale of levy free sugar and concession in the rate of excise duty rebate were capital receipts not liable to tax. [1]

31. Transactions in Assessee's Ordinary Line of Business. --If a transaction is in the assessee's ordinary line of business, there can be no difficulty in holding that it is in the nature of trade. [2] A banker's or financier's dealings in foreign exchange [3] or his sales of securities and shares [4] are, as a general rule, in the course of his business. So are a ship-broker's purchases of ships in his own name, [5] or sales of passenger ships by a company carrying on business as ship-builders and repairers and also operating a passenger boat service, [6] or a sale of a colliery by a coal mining and coal prospecting company, [7] or a share broker's purchases of shares on his own account. [8] Where a firm of cotton brokers deals in cotton for actual delivery and some of the partners on their own account speculate in cotton futures, the transactions in futures are in the line of the partners' ordinary business and the resulting profit is chargeable to tax. [9] Where a construction company assigns its contract of construction to another company, the amount received on such assignment being in the normal course of business would be a revenue receipt. [10] Sometimes, even transactions in the ordinary line of the assessee's business may be on capital account. [11] Sales of land taken over by a money-lender from a debtor in liquidation of a debt are dealt with under 'Land and buildings'.

Illustrations

1. At the time of a serious crisis in the cotton market, the assessee, a cotton merchant, was appointed under a power of attorney as an agent for the sale and disposal of all the cotton bales which had been purchased by a certain firm. It was a venture of considerable magnitude and the assessee earned a very large sum by way of commission. Held, the adventure was extraordinary, but it was connected with the business carried on by the assessee as a cotton merchant. [12]
2. A company carried on business *inter alia* as selling agent for various colliery companies. In the course of its business it had to purchase wagons on behalf of its clients. Anticipating a steep rise in prices due to war, it bought a large number of wagons on its own behalf, not for use but to sell again at a profit. The profit on the re-sale was held to be taxable as being made 'in the operation of the company's business'. [13]
3. The assessee was a motor engineer and also a partner in a land development scheme. He purchased two farms on his own account and sold them at a profit. He did not effect any development on the farms nor did he advertise or otherwise offer them for sale. The profit was held to arise from business. [14]

32. Transactions Outside Assessee's Ordinary Line of Business. --Where the transaction is outside the assessee's line of business, it depends upon the facts and circumstances of each case whether the transaction is in the nature of trade. [15] Where a transaction is not in the line of business of the assessee but is an isolated or single instance of a transaction, the onus is on department to prove that the transaction is an adventure in the nature of trade. [16] The general principles set out in the following paragraphs are useful in ascertaining whether a venture outside the assessee's line of business is in the nature of trade or not.

33. Some Transactions in Course of and Some Outside Trade. --Where a person has effected several transactions of purchase and sale, some of the sales may be of capital investments and the other sales in course of business. [17] Though a man may be found to be carrying on a trade in the buying, developing and selling of land, he may still hold and deal with some lands as capital investments outside his trade; such investments would not be trading assets and their sales would be on capital account. [18] Likewise, the sales of some buildings by a builder may be sales of capital investments. [19]

34. Shares and Securities. --The profit or loss on the sale of shares and securities would be capital if the seller is an ordinary investor realising his holdings but it would be revenue if he carries on a business in shares and securities or his dealing in them constitutes adventure in the nature of trade. [20] The profit is revenue where the realisation or conversion of shares or securities is in the course of the carrying on, or carrying out, of a business. [21] The finding of whether the dealing in shares is business income or capital gains must be decided on the basis of the frequency, volume and magnitude of transactions. [22] In the absence of any evidence or trading activity in cases of purchase and re-sale of shares, [23] the court reversed the finding of the tribunal and held the profit arising from the re-sale to be accretion of capital.

Viscount Maugham observed in *Punjab Co-op. Bank Ltd. v CIT,* [24] that liability to tax arises on sales of investments, where the sales are in course of business, although the taxpayer may not be carrying on a separate and severable business of buying and selling investments with a view to profit. The realisation or conversion of securities by banks, [25] loan and finance companies [26] and insurance companies [27] is generally held to yield trading profit, for varying investments and turning them to account are among the appointed means of such companies' gains. The sale of some of its securities by a bank, in the orders to meet withdrawals by depositors, [28] is a normal step in carrying on the company's business and the profits made on such a sale are on revenue account. However, the realisation of a banking or insurance company's investments would result in an accretion of capital if the particular transaction is found to be purely on capital account and not in course of business, [29] although it might have gone into the revenue account in the books of the company. [30] An investment company may merely hold shares and securities as capital investments, or may deal in them as stock-in-trade. [31] Any profit made by other companies on the realisation of shares or securities would be part of the profits of trade, if the dealings constitute, or are in course of, business; [32] but on this point the 'objects clause' in the memorandum of association is not conclusive. [33] It is immaterial whether the profit or loss is on sale of the shares or on liquidation of the company in which the shares are held. [34] Where there is a clear finding that the shares had never been held as a stock-in-trade, the income from such shares could only constitute capital. [35]

Loss arising on the sale of Government bonds or securities which were purchased by a businessman under pressure of governmental authorities or merely to gain a business advantage would be deductible as a revenue business loss. [36] Similarly, loss arising from purchase and sale of shares in the ordinary course of business is deductible as business loss. [37]

The Supreme Court held in *Kishan Prasad & Co. Ltd. v CIT,* [38] *Ramnarain Sons Ltd. v. CIT,* [39] and *CIT v. National Finance Ltd.,* [40] that profits or losses made on sale of shares acquired merely with the intention of obtaining a managing or selling agency or a directorship, and not of dealing in the shares, would be on capital account. [41]

The Supreme Court ruled in *CIT v Madan Gopal Radhey Lal,* [42] that if an assessee is allotted bonus shares