CIVIL REFERENCE.

Before Addison and Bhide JJ.

1931

Feb. 27

THE BHARAT INSURANCE CO., LTD., LAHORE—Petitioner.

versus

THE COMMISSIONER OF INCOME TAX, PUNJAB—Respondent.

Civil reference No. 26 of 1930.

Indian Income Tax Act, XI of 1922, sections 3, 10 (2) (iii) and (ix)—Insurance Company—"profits"—participated in by policy-holders as bonus—whether assessable to tax.

The petitioning Insurance Company has two kinds of policy-holders, *viz.* those who are entitled to participate in the profits of the Company and those who are not so entitled. According to the rules of the Company, the policy-holders of the first kind are entitled to 90 *per cent.* of the profits of the Company on that part of the business. This sum was not actually distributed amongst the policy-holders, but the capitalised value of the amount which would have to be ultimately distributed amongst the policy-holders was included in the profits of the Company on which the income-tax was assessed. The Company objected that the sum so ascertained really represented expenditure of the Company incurred solely for the purpose of earning its profits and as such should have been exempted from assessment under clause (*ix*) of sub-section 2 of section 10 of the Income Tax Act.

Held, that the share of the profits payable to policy-holders, in the circumstances of the present case, is a part of the profits of the corporation and as such assessable to income tax.

Last v. *London Assurance Corporation* (1), followed.

The "profits of a business" for the purposes of the Act mean "the net proceeds of the concern after deducting the necessary outgoings without which those proceeds could not

(1) (1884) 2 Reports of Tax Cases 100.

be earned," and these net proceeds must be taken to be the basis for the assessment of income-tax irrespective of their subsequent application or allocation. The dividend paid to the share-holders is by no means necessarily equivalent to the real profits of a Company.

Mersey Docks and Harbour Board v. *Lucas* (1), and *Secretary to the Board of Revenue Income Tax* v. *Arunachalam Chettiar*, per Wallace, C. J. (2), relied upon.

Held further, that section 3 of the Act is subject to the other provisions of the Act and must be read along with section 10, according to which only certain deductions are permissible in estimating the "profits." Under clause (*iii*) of sub-section 2 of section 10, *e.g.*, interest on capital cannot be deducted from profits, *if that interest is in any way dependent on the earning of the profits*, although the payment of such interest must necessarily reduce the amount available for distribution amongst the shareholders. The present case is in its essence of the same type, the bonuses paid to such policy-holders being in the nature of additional interest dependent upon the existence of profits.

Held also, that any departure from the interpretation of the law established by practice in this country would require very cogent reasons.

Baleshwar Bagarti v. *Bhagirathi Dass* (3), *Mathura Mohan Saha* v. *Ram Kumar Saha* (4), and Sundaram's Law of Income Tax in India, 2nd Edition, page 585, referred to.

Case referred by Mr. W. R. Pearce, Commissioner of Income Tax, Punjab, with his No. R-14 (i)-7, dated the 4th August 1930, for orders of the High Court.

MADAN GOPAL and BADRI NATH, for Petitioner.

JAGAN NATH AGGARWAL and R. C. SONI, for Respondent.

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(1) (1883) 2 Reports of Tax Cases 25. (3) (1908) I. L. R. 35 Cal. 701, 713.
(2) (1921) I. L. R. 44 Mad. 65, 73. (4) (1916) I. L. R. 43 Cal. 790.

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BHIDE J.—This is a reference under section 66 (2) of the Indian Income Tax Act, 1922, in which the following question of law has been referred to this Court for decision :—

"Whether the sum of Rs. 4,68,394 distributed amongst the participating policy-holders represents part of the profits assessable to income-tax or an expenditure incurred for earning the profits of the Company."

The material facts bearing on the question are briefly as follows :—The Bharat Insurance Company, on whose application the reference has been made, has two kinds of policy-holders, *viz.* those who are entitled to participate in the profits of the Company and those who are not so entitled. According to the rules of the Company, the policy-holders of the first kind are entitled to 90 *per cent.* of the profits of the Company on that part of the business. A periodical valuation of the profits of the Company is made every five years. In the quinquennial report for 1923-24, on the basis of which income-tax was assessed for the next five years, a sum of Rs. 4,68,394 was shown as 'allocated for distribution amongst policy-holders with immediate participation.' This sum was not actually distributed amongst the policy-holders, but represented (as was stated before us at the hearing) the capitalised value of the amount which would have to be ultimately distributed amongst the policy-holders. The sum of Rs. 4,68,394 was included in the profits of the Company on which the income-tax was assessed according to the practice followed up till now, and the Company also paid the tax up to 1929-30 without demur. In that year, too, no objection was raised before the income-tax officer, but an appeal was lodged before the Assistant Commissioner of Income-

tax, in which an objection was raised for the first time that the aforesaid sum of Rs. 4,68,394 really represented expenditure of the Company incurred solely for the purpose of earning its profits and as such should have been exempted from assessment under clause (*ix*) of sub-section 2 of the section 10 of the Income Tax Act. The appeal was rejected by the Assistant Commissioner. The Company then presented an application for a review of the case under section 33 of the Act or, in the alternative, for a reference to this Court under section 66 (2). The Commissioner of Income Tax rejected the application for review, but has referred the question stated at the outset for the decision of this Court.

The contention of the learned counsel for the Bharat Insurance Company is that the policy-holders, who participate in the profits, have to pay a higher premia and 90 *per cent.* of the profits are offered to the policy-holders merely to attract a larger capital for the business of the Company. The policy-holders are not constituents of the Company like share-holders and the share of the profits, which is paid to them, is really in the nature of expenditure, which the Company has to incur for earning the profits. Under section 3 of the Indian Income Tax Act, it is the profits of the Company which are chargeable and the profits paid to the policy-holders, who are not included amongst its constituents, cannot, therefore, be properly included in the profits of the company. No Indian authority on the point was cited. As regards the English authorities, the precise question, which has been referred to us for opinion, seems to have been raised in *Last* v. *London Assurance Corporation* (1).

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This case went up to the House of Lords and, though there was a difference of opinion amongst the Judges, the ultimate decision of the majority was that the share of the profits paid to policy-holders in circumstances similar to those of the present case is a part of the profits of the Corporation and as such assessable to income-tax. The learned counsel for the Bharat Insurance Company sought to distinguish this case on the ground that there are differences between the provisions of the Indian and the English Income Tax Act.

It will appear from the above that the decision of the question referred in this case depends mainly on the interpretation of the word 'profits' for the purpose of the assessment of the Company to income-tax. There is no definition of the word given in the Act itself. There is no doubt that the amount in dispute has been treated by the Company itself as a portion of its 'profits;' for it is described as equivalent to 90 *per cent.* of the 'profits' and is payable to policy-holders who have taken endowment policies 'with profits.' The learned counsel for the Company has, however, argued that this is only a loose use of the word and, strictly speaking, the amount in question is a part of the expenditure of the Company, which must be deducted before we can arrive at the true profits of the Company.

In *Mersey Docks and Harbour Board* v. *Lucas* (1), the word 'profits' was interpreted by the House of Lords to mean 'the net proceeds of a concern after deducting the necessary outgoings without which those proceeds could not be earned or received,' or income of whatever character it may be, over and above the costs of receipt and collection,' and the 'gains of a trade'

(1) (1883) 2 Reports of Tax Cases 25.

were taken to be 'whatever was gained by the trading, for whatever purpose it was used.' The same view was adopted by the majority of that House in *Last* v. *London Assurance Corporation* (1).

There is nothing to show that the word 'profits' is used in a different sense in the Indian Income Tax Act. In *Secretary to the Board of Revenue Income Tax* v. *Arunachalam Chettiar* (2), a similar interpretation was adopted by a Special Bench of the Madras High Court on the basis of several English decisions and it was pointed out by Wallace C. J. in his judgment that "having regard to the uniform interpretation placed by the Courts on the corresponding language of Schedule D and accepted by the legislature it is not open to this Court to place a different interpretation on the word 'profits' occurring in section 9 of the present Act, etc., etc.". The Income Tax Act then in force was the Act of 1918, but there seems to be no material difference in the provisions of that Act and the present Act so far as the point under discussion is concerned.

I must, therefore, accept the above interpretation of the word and hold that the 'profits of a business' mean the 'net proceeds of the concern after deducting the necessary outgoings without which those proceeds could not be earned,' and that these net proceeds must be taken to be the basis for the assessment of income-tax irrespectively of their subsequent application or allocation. According to section 10 of the Act, the tax is payable by the assessee 'in respect of the profits or gains' of any business carried on by him The Income Tax Officer is, therefore, concerned with the 'profits of the business' and not with the net

(1) (1884) 2 Reports of Tax Cases 100. (2) (1921) I. L. R. 44 Mad. 65, 73.

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dividend paid to the share-holders. It is true that according to section 3 of the Act the tax is chargeable on all income, profits and gains of the Company, but that section is subject to the other provisions of the Act and must be read along with section 10. It is also to be borne in mind that the Company has a separate legal entity and the dividend paid to the shareholders is by no means equivalent to the real profits of the Company.

According to section 10 of the Income Tax Act, only certain deductions are permissible in estimating the 'profits' and the word is thus used in a special sense. Certain deductions which may be permissible in an ordinary commercial balance sheet in estimating profits are consequently not permissible at all under section 10. Under clause (*iii*) of sub-section 2 of section 10, *e.g.* interest on capital cannot be deducted from profits, if that interest is in any way dependent on the earning of the profits, although the payment of such interest must necessarily reduce the amount available for distribution amongst the shareholders. The present case is, in its essence, of the same type. The premia paid by the policy-holders are a part of the capital of the Insurance Company. Policy-holders who participate in the profits have to pay higher premia and the bonuses paid to such policy-holders are in the nature of additional interest paid to these policy-holders. But this payment is dependent upon the existence of profits and hence on the principle of clause (*iii*) of sub-section 2 of section 10 referred to above, such payment cannot be deducted in estimating the profits.

The contention of the learned counsel for the Company that the payment of the bonus is really an

expenditure incurred solely for earning the profits does not appear to be sustainable. Any expenditure incurred solely for the purpose of earning profits would ordinarily precede and not follow the accrual of the profits. It would certainly not be dependent on the existence of those profits. In the present instance, the participating policy-holders are paid the bonuses only if there is any profit but not otherwise. In other words, the expenditure has not necessarily to be incurred for the purpose of the business but is contingent on the existence of a surplus. Again the payment of bonuses may have different objects in view and may not be intended solely for earning higher dividends for the share-holders even if the word 'profits' were to be understood in that restricted sense. The object, for example, may be the creation of a larger Reserve Fund out of the larger surplus of income over expenditure, for the stability of the Company. In these circumstances I do not think these bonuses can be properly considered to be an expenditure 'incurred solely for the purpose of earning the profits.' As held by Lord Blackburn in *Last* v. *London Assurance Corporation* (1), the bonuses seem to represent really a share in the profits of the business of the Company purchased by the participating policy-holders.

The learned counsel for the Company has urged that there are some differences between the English and the Indian Income Tax Statutes, but he has not been able to point out any which may be considered to be material for the purposes of the present issue. The Indian Act is based largely, as is well known, on the English Act. Here as in England the tax is payable on the profits of a business and in calculating

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the 'profits,' certain deductions are permissible while others are not. The learned counsel for the Company drew our attention to section 54 of 5 and 6 Vic., Chapter 35, to which Lord Blackburn has referred in his judgment in *Last* v. *London Assurance Corporation* (1). According to this section an estimate of the profits and gains has to be made in England before 'any dividend shall have been made thereof to any other persons, corporations, or Companies having a share, right, or title in or to such profits or gains.' But the interpretation of this provision was itself a subject of difference of opinion amongst the Judges and the judgment of Lord Blackburn mentions this provision only incidentally and is not based on it. The learned counsel further stated that in England bonuses paid to policy-holders were subsequently exempted from income-tax subject to certain reservations (*cf.* section 16 of the Finance Act, 1923). It is, of course, open to the Legislature to adopt the same course in this country. We are concerned only with the interpretation of the law as it stands. After carefully considering the provisions of the Indian Income Tax Act, I am unable to see any good grounds to justify a different view being taken in the present case to that taken by the House of Lords in *Last* v. *London Assurance Corporation* (1).

The established practice in this country is apparently in accordance with that view (*cf.* Sundaram's Law of Income Tax in India, 2nd edn., page 585). Any departure from the above interpretation of the law would, therefore, require very cogent reasons (*cf.* *Baleshwar Bagarti* v. *Bhagirathi Dass* (2) and

(1) (1884) 2 Reports of Tax Cases 100. (2) 1908) I. L. R. 35 Cal. 701, 713.

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Mathura Mohan Saha v. *Ram Kumar Saha* (1) and no such reasons have been, I think, made out in the present case.

For the reasons stated above it seems to me that the aforesaid sum of Rs. 4,68,394 allocated for distribution amongst the participating policy-holders must be considered to be a portion of the profits of the Company and as such assessable to income-tax and not an expenditure incurred solely for earning the profits within the meaning of clause (*ix*) of sub-section (2) of section 10 of the Indian Income Tax Act, 1922. I would answer the question accordingly, but as the law point involved is not free from difficulty, I would make no order as to costs.

ADDISON J.—I concur.

ADDISON J.

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(1) (1915) I. L. R. 43 Cal. 790.