Commissioner Of Income-Tax, Bombay ... vs Jubilee Mills Ltd. on 17 September, 1962

Equivalent citations: [1963]48ITR9(SC), AIRONLINE 1962 SC 14, (1963) 48 ITR 9

JUDGMENT

The judgment of the court was delivered by :

HIDAYATULLAH J. - This is an appeal on a certificate of fitness granted by the High Court of Bombay against the judgment of the High Court dated March 13, 1958, on a reference made by the Income-tax Appellate Tribunal. The Commissioner of Income-tax, Bombay City I, is the appellate and the Jubilee Mills Ltd., Bombay, the respondent. The only question raised in this appeal is the application of section 23A of the income tax to the assessee company.

The assessee company is a limited liability company with a paid up capital of Rs. 15,25,000. Its paid up capital is made up as under :

Rs.

1 lakh ordinary shares of Rs. 10 each 10,00,000 5,000 cumulative preference shares of Rs. 25 paid up 1,25,000 4,000 second preference shares of Rs. 100 each fully paid up 4,00,000 The second preference shares do not entitle the holders to vote. Thus shares of the assessee company carrying votes are 1,05,000. This was the position on June 30, 1947. We are concerned with the assessment year 1948-49 corresponding to the previous year ended on June 30, 1947. In that year, the company was assessed on a total income of Rs. 7,47,639. The Income-tax Officer calculated the tax at Rs. 4,20,548. In that year, the company ought, if section 23A was applicable, to have distributed 60% of the above amount. The company, however, declared dividends which is the aggregate amounted to Rs. 24,750. The Income-tax Officer, with the previous approval of section 23A, of the Income-tax Act and held that the company was deemed to have declared dividend of Rs. 3,97,788.

The assessee company was being managed by a firm called Mangaldas Mehta & Co. That firm consisted of fourteen partners of whom seven were the directors of the assessee company. The members of the managing agents who were also directors held between them 35,469 ordinary shares and 880 first preference shares. The remaining seven members of the managing agents, who were not directors of the assessee company, held respectively 41,659 and 370 shares of the two categories. Seventy-five shares were held by Girdhardas & Co. Ltd., to which company admittedly

section 23A was applicable. Some of the members of the managing of the managing agency firm held on behalf of their minor children or on behalf of their families 9,899 ordinary shares and 937 first preference shares. The following is a detailed break-up of the share holdings :

CATEGORY A Shares held by directors who are partners in the firm of managing agents Holding of ordinary shares Share in the partnership firm of managing agents firm Holding of the Ist preference shares

1. Shri Homi Mehta Nil

2.Sheth Mathurdas Mangaldas Parekh 6,466

3. " Madan Mohan Mangaldas 11,052

4. " Madhusudan Chamanlal Parekh 3,616

5. " Mahendra Chamanlal Parekh 3,616

6. " Surendra Mangaldas Parekh 7,053

7. " Indrajit Chamanlal Parekh 3,616 35,469 CATEGORY B Shares held by partners of managing agents firm excluding the holding of the directors who are also partners as shown above Holding of ordinary shares Share in the partnership firm of managing agents firm Holding of the Ist preference share

1.Shri Harshavadan Mangaldas 11,053

2.Mrs.Savitagavri Chamanlal Parekh 3,750

3.Shri Virendra a minor by his Chamanlal mother and Parekh guardian Mrs.Savitagavri Chamanlal Parekh 6,328

4.Shri Manmohan Chamanlal Parekh do.

4,462

5.Shri Kamal-Nayan Chamanlal Parekh do.

4,962

6.Shri Nutan Chamanlal Parekh do 4,962

7.Shri Hussein Essa 6,142 Nil 41,659 CATEGORY C Shares represented by the directors Holding of ordinary shares Holding of the 1st preference shares

1.Sheth Madhusudan Chamanlal Parekh (No. 4, in A above) as karta of the joint family estate of Sheth Chamanlal Girdhardas Parekh 3,899

2.Sheth Mathuradas Mangaldas Parekh (No.2 in A above) as guardian and father of minor, Ben Purnima Mathuradas.

1,000

3. do do Ben Veena 1,000

4. do do Ben Sunita 1,000

5. do do Jagatkumar Mathuradas 1,000

6.Sheth Surendra Mangladas Parekh (No.6 in A above) as guardian and father of minor, Darshan Surendra Parekh 1,000

7. do. as guardian and father of minor Ben Babi Suren-dra Parekh 1,000 9,899 It appears that in the past the assessee company incurred heavy losses and it had to reconstruct its capital in 1930 because it had a debit balance of Rs. 12,75,000 in the profit and loss account which had to be paid out of capital. This was done by reducing the face value of the ordinary shares from Rs. 100 to Rs. 10 each, and of the preference shares from Rs. 100 to Rs. 25, each after obtaining the approval of the High Court. It is the reconstituted capital which has been shown by us in an earlier part of this judgment. It also appears that the Income-tax Officer granted to the assessee company a rebate of one anna under proviso (a) to paragraph (b) of part I of the second schedule of the finance Act. 1948. This rebate was granted to those companies to which the provisions of section 23A were not applicable. Subsequently, the Income-tax Officer, as stated already, applied section 23A to the company and it was contended that he was incompetent to do so as he must be deemed to have impliedly held already that section 23A was not applicable. Section 23A before its amendment in 1955, in so far as it is material, read as follows :

> "23A. Power to assess individual members of certain companies. -
>
> (1) Where the Income-tax Officer is satisfied that in respect of any previous year the profits and gains distributed as dividends by any company up to the end of the sixth month after its accounts for that previous year are laid before the company in general meeting are less than sixty per cent. of the assessable income of the company of that previous year, as reduced by the amount of income tax and super tax payable by the company in respect thereof he shall, unless she is satisfied that having regard to losses incurred by the company in earlier years or to the smallness of the profit made, the payment of a dividend or a larger dividend than that declared would be unreasonable, make with the previous approval of the Inspecting Assistant Commissioner an order in writing that the undistributed portion of the assessable income of the company of that previous year as computed for income tax purposes

> and reduced by the amount of income tax and super tax payable by the company in respect thereof shall be deemed to have been distributed as dividends amongst the shareholders as at the date of the general meeting aforesaid, and thereupon the proportionate share thereof of each shareholder shall be included in the total income of such shareholder for the purpose of assessing his total income....

Provided further that this sub-section shall not apply to any company in which the public are substantially interested or to a subsidiary company in which the public are substantially interested or to a subsidiary company of such a company if the whole of the share capital of such subsidiary company is held by the parent company or by the nominees thereof.

Explanation. - For the purpose of this sub-section, -

a company shall be deemed to the a company in which the public are substantially interested if shares of 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 twenty five per cent, of the voting power have been allotted unconditionally to, or acquired unconditionally by, and are at the end of the previous year beneficially held by the public (not including a company to which the provisioned of this sub-section apply), and if any such shares have in the course of such precious year been the subject of dealings in any stock exchange in the taxable territories or are in fact freely transferable by the holders to other members of the public."

We are really concerned with the application of the Explanation to the facts of this case. The Explanation, in so far as it is relevant to our purpose, says that a company shares of the company carrying not less than 25 per cent of the voting power have been allotted unconditionally to, or acquired unconditionally the public and are held beneficially by the public.

The Income tax Officer held that this was not a company in which the public were substantially interested and that the grant of the bate earlier by him did not estop him from applying section 23A to this company. His order was upheld by the Appellate Assistant Commissioner and the Tribunal on both the points. The assessee company then applied for decision by the High Court :

> "(1) Whether, on the facts and in the circumstances of the case, the Income tax Officer was competent to pass an order under section 23A(1) of the Act after having allowed a rebate of one anna per rupee in the assessment under proviso (a) to paragraph (B) of part I of the Second Schedule of the Finance Act, 1948 ?
>
> (2) If the answer to question No. 1 is in the affirmative whether, on the facts and in the circumstances of the case, the assessee company is a company in which the public are substantially interested for the purposes of section 23A of the Act ?
>
> (3) Whether the loss of Rs. 12,75,000 incurred by the company, Prior to its reconstruction in 1930, could be taken in to consideration for purposes of the applicability of section 23A(1) of the Act ?"

The High Court, by the judgment under appeal, answered the first two questions in the affirmative and in view of the answer to question No. 2 it considered it unnecessary to answer the third. The Commissioner of Income tax obtained a certificate of fitness and filed the present appeal.

The answer to the first question is in favour of the Commissioner of Income tax. The other side has not appealed and Mr. Viswanatha Sastri for the assessee company concede before us that the High court was right. The third question depends on the answer to the first question but as it has not been answered by the High Court we do not consider it necessary to answer it here for the first time. We shall now address ourselves to the second question.

The Tribunal in dealing with the question whether the public could be said to hold 25 per cent. or more of the voting power in the assessee company took into consideration a decision of the privy Council in Commissioner of Income-tax v. Bjordal and held that though the directors, qua directors, do not cease to be members of the public, the holding of the group of fourteen individuals who collectively formed the managing agency firm of Mangaldas Mehta & Co. Could not be counted as held by the member of the public in this case for purposes of the Explanation. The Tribunal was further of the opinion that this group of persons had a "juristic personality" and it should be taken into account as a group in determining where the controlling power vested according to the test laid down by the Privy Council in the said case.

The High Court reversed the decision of the Tribunal following its earlier decision reported in Raghuvanshi Mills Ltd. v. Commissioner of Income tax. In that case the High Court had held that directors, qua directors, must be contrasted with the public and if the directors held more than 75 per cent. of the voting power then alone the company interested. The High Courts view was that the managing agents act under the direction of the directors and unless the directors were themselves controlling the voting power above the limit stated by the Explanation, the company must be regarded as one in which the public were substantially interested. Applying the same test to the present case, the High Court found that the directors between them held only the shares which we have shown in tabular form under category "A". Since the number of these shares was not up to the mark to attract section 23A, the High Court answered the second question in favour of the assessee company. The request of the department that a supplemental statement of the case be asked from the Tribunal as to whether any person belong in g to categories "B" and "C" was so much within the control of the directors as not to hold the shares unconditionally or beneficially for himself was rejected by the High Court observing that this would give a second chance to the department to lead further evidence. Following the decision of the House of Lords in Thomas Fattorini (Lancashire) Ltd. v. Inland Revenue Commissioners they refused to take action under section 66(4). The High Court took notice of the fact that the privy council in Bjordals case had indicated a test to determine what is meant by "public" which was different from that indicated by them in Raghuvanshi Mills case. They, however, held that after 1950, the decisions of the Privy Council had only a persuasive authority and the decision of the High Court was binding in the absence of a decision by this court. They therefore, applied their own decision in Raghuvanshi Mills case and decided this case accordingly.

It may be pointed out that the High Court did appreciate the point of view expressed by the Privy Council in the above mentioned case. They observed as follows :

> "It may be that out view is erroneous and it may be - and very probably it is - that the view taken by the Privy Council is the right one. But, as we have said, so long as the judgment of the Bombay High Court stands, it was the duty both of the department and of the Tribunal to give effect to that decision."

Section 23A is not applicable to a company in which the public are substantially interested. What is "substantial" interest of the public is stated in the Explanation. That interest represented in terms of the share holding must not be less than 25% of the total number of the total number of the "public" unless he holds the shares unconditionally and beneficially for himself, What is meant by "unconditionally" and : "beneficially" was explained by this court in an appeal against the decision of this court is reported in an appeal against the decision of the High Court of Bombay in Raghuvanshi Mills case. The decision of this court is reported in [1961] 41 I.T.R. 613. This court pointed put that by the words "unconditionally" and "beneficially" is indicated that the voting power arising from the holding of those shares should be free and not within the control of some other shareholder and the registered holder should not be a nominee of another. It was pointed out again by this court in Shree Changdeo Sugar Mills Ltd. v. Commissioner of Income-tax that by "unconditional" and "beneficial" holding is meant that the shares are held by the holders for their own benefit only and without any control of another.

This court approved the decision of the Privy council in Bjordals case that directors, qua directors, are not without the pale of the public. This court pointed out that what one has to find out is whether there is an individual who, or a group acting in concert which, controls or control the affairs of the company to the exclusion of others by reason of his or their voting power. Such person or group of persons do not answer the description "public". There is nothing inherent in the office of directors which would lead one to think that the directors must act in unison. They are persons in whom the share holder have reposed confidence and on whom they have conferred powers which, under the scheme of the companies Acts, have to be exercised for the benefit of the shareholders. The directors are, in a manner of speaking, trustees of these powers. It is the duty is the directors to exercise these powers to the best of their independent judgment. There is therefore, nothing in the nature of things or at all that requires the directors to act in unison. This court pointed out in Raghuvanshi Mills case that such a group may be composed of directors or their nominees or relations in different combinations or may be composed of persons none of whom is a director provided such a group forms a block which holds the controlling interest in its hands.

It would therefore, follow from what we have stated that we have first to see whether there is an individual or a group holding the controlling interest which group acting in concert can direct the affairs of the company at its will. The controlling interest, of the course, is effective only if the group owns 51% of the total shares. But the company will still be a company in which the public can be said to be substantially interested because to cease to be so the shareholding of the group must be more than 75%. In the group, any person, be he a director or a non director, a relative of a director, a promoter of the company, or a stranger, may be included but only if belonging to a group or as

holding the shares as a nominees of someone else belonging to the group. We have indicated again the true test which was not applied in the judgment of the Bombay High Court in Raghuvanshi Mills case and applying which we reversed that decision.

Applying the above test, owe have to see whether there is such a group in this company. It is obvious from what we have said that category "A" which consisted of the directors could not be regarded as outside "public" merely by reason that they were directors. But there is, however an intimate connection between category "A" and category "B" inasmuch as both are members of the managing agency firm. In other words, there is evidence of yet another group, namely, the group of shareholders who constitute the managing agency firm.

We agree with the High Court that managing agents act under the control and direction of the directors. The managing agents are also appointed by the company. The control of the affairs of a company is ordinarily in the hands of the directors of the company but there may be cases in which the managing agents, by reason of their superior holding of shares may be able to appoint the directors and generally to control the views of the directors. Where the managing agents hold an interest which is small and is thus not capable of exercising an overriding power, other evidence may be required to show that they, in conjunction with others, are running the affairs of the company to the exclusion of the public. Where, however, the managing agents admittedly hold 51% or more of the shares, it is obvious that the controlling interest belongs to the managing agents, either by themselves or with those who act in concert with them, hold shares above the 75% limit they can be regarded as constituting a group which cannot be counted as "public". In such a case the holding of the managing agents, if above 75% may furnish proof that the company is one in which the public are not substantially interested. It was contended before us that even among the managing agents some may take an independent view. Normally, managing agencies are not informed by parties except for the purpose of mutual gain and the commonness of the interest lends a cohesion to the body which enables it to act in its own interest. When such a body holds shares carrying more than 75% of the voting power the company itself is run mainly as the managing agents desire it to be run. such a managing agency could easily choose its own directors and the directors would not be independent persons but mere nominees of the managing agents. In such a case the inference is irresistible that we have a group, which, as a group can run the company at its will and which not only controls the voting at the meeting of the shareholders but, by selecting its own directors, gets the directors to act according to its own desires. No member of such a managing agency firm can be regarded as belonging to "the public" and when this happens the company comes within the reach of section 23A.

Applying the above test to the present case, it is clear that the managing agents between them hold 77,128 out of 1,00,000 ordinary shares, well above the limit. They have in addition 1,250 first preference shares out of 5,000 which also carry voting power. To this must be added 75 shares held by Girdhardas & Co. Ltd. to which section 23A is admittedly applicable. This brings the total holding to 78,453. 75% of the total shares bearing votes is 78,750. This shows that the holding of the managing agents is short by 298 shares for the application of the explanation to section 23A. But when we turn to category "C" we find that 6,000 shares were held by the members of the managing agency on behalf of minor children and the voting power arising from these shares was in their own

hands as guardians. There is no doubt that in the present case shares carrying more than 75% of the voting power are held by this court in Raghuvanshi Mills case and by us here. The reason is this : Shares carrying more than 75% of the voting power are held by the partners of the managing agency firm or persons under its control. Now it seems to us that it is to the interest of the partners of this firm to exercise their voting power in one way, namely, the way that brings to them the largest profit out of the company. It is true that the managing agents are the servants of the company in a manner of speaking and not its masters and also that the object of a firm of managing agents is to carry out certain administrative duties concerning the company under the control of the directors of the company. That, however, is irrelevant and in any case is far from the truth in the present case. Here the partners of the managing agency practically own the company.

At the hearing a point was raised that it has to be proved as a fact that the persons constituting the group, which owns shares carrying more than seventy-five per cent. of the voting power, were acting in unison. The test is not whether they have actually acted in acted in concert but whether the circumstances are such that human experience tells us that it can safely be taken that they must be acting together. It is not necessary to state the kind of evidence that will prove such concerted actings. Each case must necessarily be decided on its own facts. The exclusion of "public" in the manner indicated generally from more than 75% of the shares and the concentration of such a holding in a single person or a group acting in concert is what attracts 23A.

In our opinion, the High Court was not right in answering the second question in the affirmative. The appeal is allowed. The answer of the High Court is set aside and the question is answered in the negative. The respondent shall pay the costs here and in the High Court.

Appeal allowed.