

1939

Present : Hearne and de Kretser JJ.

## COMMISSIONER OF INCOME TAX v. MACAN MARKAR

12—D. C. (Inty.) Special

*income tax—Bonus to shareholder—Shares issued, as fully paid up, for capitalization of profits—Meaning of dividend—Income Tax Ordinance, s. 2 (Cap. 188.)*

Fully paid up shares issued to the shareholder of a company by way of capitalizing the profits of the company do not constitute a dividend as defined by section 2 of the Income Tax Ordinance so as to render the shareholder liable to tax on their value.

**T**HIS was a case stated by the Board of Review under section 74 of the Income Tax Ordinance.

The facts are stated as follows :—

Sir H. M. Macan Markar was notified in September, 1938, of an additional assessment of Rs. 68,712, in respect of the year of assessment, 1936-37, and was called upon to pay a tax of Rs. 3,280.05 on this additional assessment. The sum assessed was said to be a "dividend" received from The Galle Face Land & Building Company, Limited.

The Company is a private company and, except for five shareholders holding one share each, the entire capital is owned by four members of the appellant's family. In February, 1936, the Company resolved to use Rs. 250,000 out of its reserve fund for the payment of a bonus to shareholders, in proportion to the amount paid up on their shares, by the issue of 2,500 fully paid up shares of the Company of Rs. 100 each.

These 2,500 fully paid shares were duly issued to the four principal shareholders (except for 48 shares which were held for charity). The assessee received 793 shares.

The Income Tax Assessor was of the view that this distribution was a "dividend" as defined in section 2 of the Ordinance and as such was taxable in the hands of the recipient (except as to so many of the shares as represented profits arising in the accounting periods ended before April 1, 1936). The assessee was accordingly assessed to pay a tax on Rs. 68,712 in addition to the tax he had already been assessed for the year of assessment, 1936-37.

The assessee appealed to the Commissioner against the assessment on the ground that the distribution of shares was not a "dividend" within the meaning of the Income Tax Ordinance, and was accordingly not taxable.

The Commissioner referred the appeal to the Board of Review, under the provisions of section 72 of the Income Tax Ordinance. The appeal was heard by the Board of Review on November 14, 1938.

At the hearing it was agreed between the parties, that the undistributed profits of the Company had been capitalized and that as a result of the issue of all these bonus shares the capital of the Company had been



increased by Rs. 194,958; that the resolutions of the Company and of its Directors relative to the distribution of the reserves by the issue of shares were *intra vires* the Company; and that these shares had been issued as fully paid shares. There is also no dispute on the amount of tax payable, if liability to tax attaches.

The assessee produced the balance sheet of the Company to the year ending June 30, 1935, (marked A 1) and to the year ending June 30, 1936, (marked A 2) and a series of letters between him and the assessor (marked A 3 to A 9). Copies of all these documents are annexed to this case stated. It was contended on his behalf that it was lawful for a company to capitalize its profits and that once they were effectually capitalized, the distribution of them in the shape of shares was a distribution not of profits or income but of capital. Counsel argued that the shares distributed did not fall within the meaning of "dividend" in section 2 of the Income Tax Ordinance as that section only professed to tax any *profit* distributed in the form of shares, and that once the character of profits was taken away by effective capitalization, no tax could be levied.

The assessor contended that the shares received by the assessee fell within the definition of "dividend" in section 2; that no shares could be issued which were not part of the capital of the Company, and that if the contention of the assessee was correct, in no case would shares distributed as dividend be liable to tax despite the definition of "dividend" as in every case a distribution of shares would be said to be an issue of capital and not a distribution of "profits". It was urged that the manner in which the Company chose to treat its income could not take away from that income the character of "profits"; that any dealings with it by the Company could not affect its taxability as "profits". He relied upon the provisions of clause 147 of the Articles of Association of the Company (which is annexed hereto marked R 1) which he argued, showed that the Company's Articles themselves treated the reserves as undistributed profits.

The Board upheld the contention of the assessee and annulled the additional assessment.

J. W. R. Ilangakoon, K.C., Attorney-General (with him S. J. C. Schokman, C.C.), for the Commissioner of Income Tax, appellant.—The question of law for determination is whether the 793 bonus shares received by the assessee who is a shareholder in a private company constitute a dividend within the meaning of section 2 of the Income Tax Ordinance. The charging section is section 5. "Profits and income" is defined in section 6 and includes dividends.

It is common ground that the reserve fund out of which the bonus was issued consisted of undistributed profits. The case stated mentions that undistributed profits had been capitalized and these shares issued as fully paid up shares. The Board of Review chose to follow certain English and Indian decisions without regard to the fact that "dividend" according to our Ordinance includes a distribution of profits in the form of shares. "Income" and "dividend" are not defined in the English Acts of 1918. There is a similar absence in the Indian Act of 1922.



The following decisions in England, viz., *Bouch v. Sproule*<sup>1</sup>, *Inland Commissioner of Revenue v. Blott*<sup>2</sup>, *Fisher's Case*<sup>3</sup>, and *Inland Revenue Commissioners v. Wright*<sup>4</sup> did not turn on a definition of the term "dividend" and were decided in favour of the taxpayer. They went on the basis that a bonus issued in the form of fully paid up shares was a distribution of capital and not income. In the case of *Swan Brewery Co. v. the King*<sup>5</sup> the Privy Council held that bonus shares came within the definition of "dividend" in the Australian Income Tax Act as being an "advantage".

See also *Commissioner of Income Tax, Bengal v. Mercantile Bank of India, Ltd., et al.*<sup>6</sup> where various English cases are reviewed.

English decisions were followed in South Africa also. In 1925, however, the law was amended and bonus shares distributed to shareholders were made taxable—*Ingram on Law of Income Tax in South Africa (1933 ed.)*, p. 190.

In the Income Tax Assessment Act, Australia (1932-34), the definition of dividend would include bonus shares. Our Ordinance was passed in 1932. The draftsman of the Ordinance apparently desired to get over the difficulty caused by *Blott's Case (supra)* and included in the definition of dividend a distribution of profit in the form of shares.

*H. V. Perera, K.C.* (with him *E. F. N. Gratiaen*), for the assessee, respondent.—Nothing is a dividend, according to our Ordinance, which is not a distribution of profits. Apart from section 2, section 52 makes it clear. Just as, in England, section 21 (1) of the Finance Act of 1922 did not in any way supersede the law as laid down in the cases already cited, similarly our law does not do so. The substance of the definition of dividend is the distribution of profit. The remainder of the definition speaks merely of the form in which the distribution of profits may be made.

What happened, in fact, was that undistributed profits were capitalized and were thus utilized to increase the assets of the Company. What had been profits at one time are now no longer in a form which can be described as profits, because they have already been utilized for the increase of the assets of the Company. Capitalization excludes all idea of dividend.

There cannot be a dividend unless there is a release of assets. English cases make it abundantly clear that a release of assets is essential for a distribution of profits—*Blott's Case (supra)*, *Fisher's Case (supra)*, *Commissioner of Income Tax, Bengal v. Mercantile Bank of India, Ltd., et al. (supra)*.

Although the word "bonus" was used, all that was intended, by the resolution of the Company, to go to the shareholder was a number of shares and not any bonus as ordinarily understood. The word "bonus" was used in the Company's resolution in *Blott's Case* too. The issue of "dividend" in form of shares is possible only when the shares are held in another company and represent realizable assets of the Company

<sup>1</sup> (1887) 12 A. C. 385.

<sup>2</sup> (1921) 2 A. C. 171.

<sup>3</sup> 10 T. C. 302.

<sup>4</sup> (1927) 1 K. B. 333.

<sup>5</sup> (1914) A. C. 231.

<sup>6</sup> (1936) A. C. 478.



which issues the "dividend"—*Pool v. The Guardian Investment Trust Co., Ltd.*<sup>1</sup>, *Commissioner of Inland Revenue v. Collins*<sup>2</sup>, *Commissioner of Income Tax v. Messrs. Binny & Co.*<sup>3</sup>, *Steel Bros. & Co., Ltd. v. Government*<sup>4</sup>.

Dividend is a distribution of profits. On authority, on principle and on the definition given in our Ordinance, the decision of the Board was correct.

J. W. R. Ilangakoon, K.C., *Attorney-General*, in reply.—The facts mentioned in the case have to be borne in mind. According to the Articles of Association, no dividend or bonus was to be distributed except out of profits. The reserve fund out of which the shares were formed represented undistributed profits. As long as profit was distributed even in the form of shares, it was taxable. See *Lever v. Land Securities Co.*<sup>5</sup>. The resolution of the Company faithfully follows the power given under Article 147.

*Cur. adv. vult.*

November 20, 1939. HEARNE J.—

This is an appeal by the Commissioner of Income Tax on a case stated by the Board of Review under section 74 of the Income Tax Ordinance.

The assessee-respondent who is a shareholder of the Galle Face Land & Buildings Co., Ltd., was called upon to pay a tax of Rs. 3,280.05 on an additional assessment in respect of certain shares he had received from the Company in the following circumstances.

In February, 1936, the Company resolved that "the sum of Rs. 235,929.96 forming part of the existing reserve for depreciation of buildings and further the sum of Rs. 14,070.04 lying to the credit of permanent reserve shall be applied towards payment of a bonus to shareholders as nearly as may be in proportion to the amounts paid up on the shares held by them and that the Directors be authorized to allot and issue to the shareholders entitled thereto in like proportions 2,500 shares of Rs. 100 each credited as fully paid up in satisfaction of such bonus".

The resolution was carried into effect and the respondent received 793 shares. The question for determination is whether the shares received by him constituted a dividend within the meaning of section 2 of the Income Tax Ordinance so as to render him liable to be taxed on their value. The Board of Review held that he was not.

In the past difficult questions have arisen as to whether distributions purporting to be by way of bonus shares constituted distributions of income or of capital.

The leading case is *Commissioners of Inland Revenue v. Blott*<sup>6</sup>. It decided that where shares credited as fully paid up were issued in satisfaction of a bonus the distribution was a distribution of capital and not of income, for the reason that the profits were not paid away to the

<sup>1</sup> (1922) 1 K. B. 347; 8 T. C. 167.

<sup>2</sup> (1923) S. A. L. R. A. D. 347.

<sup>3</sup> (1924) A. I. R. (Madras) 802.

<sup>4</sup> (1924) A. I. R. (Rangoon) 337.

<sup>5</sup> (1891) 8 T. L. R. 94.

<sup>6</sup> (1921) 2 A. C. 171.



shareholders. On the contrary they were retained by the Company and applied in paying up capital sums which shareholders would otherwise have had to contribute.

In England income is quite simply "total income from all sources", and if the question in this appeal was whether the shares were income in the ordinary sense, and independently of any statutory extension of the definition of income, it would have unhesitatingly to be answered in favour of the respondent.

In Ceylon income includes dividends and a dividend is defined "as including any distribution of profit by a Company to its shareholders in the form of money, or an order to pay money, or in the form of shares . . . ."

Dealing with the term "dividend", as it has been defined in the Income Tax Ordinance, the Attorney-General thought it probable that the draftsman had *Blott's Case*<sup>1</sup> in mind and had sought, by including the words "in the form of shares" in the definition, to provide against the implications of the decision in that case.

It is, on the other hand, possible that he fell into the error of thinking, as was thought by the Commissioners of Inland Revenue in *Pool's Case*<sup>2</sup>, that "where a bonus is paid in the shares of another Company the value of those shares, following *Blott's Case* is not assessable for the purposes of tax" and if he so thought it is probable that he used the word "shares" in the sense of "shares of another company".

Apart, however, from mere speculation, the point at issue is shortly this—is the definition of dividend wide enough to enable the Commissioner of Income Tax to insist upon the inclusion by a taxpayer, in his return of income, of an amount equal to the value of shares that may have been received by such taxpayer by way of capitalizing the profits of a company of which he is a shareholder ?

If it is wide enough, then the controversy of whether he is being taxed on income or capital becomes merely academic.

It has for instance become academic in Australia (Victoria) where the Income Tax Act, 1935, defined income as including "profits or bonuses paid *credited* or distributed from the profits of a company". The Courts there held that by the word "credited" the legislature had reached cases where, though a shareholder has not been "paid" the dividend or bonus, there has been *credit* in the Company's books imputed to the shares issued to him.

All difficulty, as it appears to me, would have been avoided if what are profits in the ordinary acceptation of that word and what is in essence capital had been dealt with separately. If, for instance, dividend had been defined as meaning any distribution of profit made by a company in money or other property *and* as including "the paid up value of shares distributed by a company to its shareholders to the extent to which the paid up value represents the capitalization of the whole or any part of the profits of the company"—(Income Tax Assessment Act, Australia, 1932-1933).

<sup>1</sup> (1921) 2 A. C. 171.

<sup>2</sup> (1922) 1 K. B. 347 ; 8 T. C. 167.



In our Ordinance, however, this has not been done. On the contrary the definition clause so far from not saying that shares issued in consequence of capitalization of profit which would ordinarily be regarded as receipts of a capital nature are, for the purposes of the Ordinance, to be regarded as income, expressly states that a dividend is a distribution, not of capital but of profit.

The definition deals with two matters—the essential character of a dividend, namely, distribution of profit, and the form it might take, for instance, shares. Looking then at what may be called both limbs of the clause, that is to say, to substance on the one hand and to form on the other shares issued to a taxpayer could be a dividend but only if they come to his hands as profit, and this was clearly not so in the present case. The Company had decided to do no more than to increase its paid up capital—and to this end to capitalize its depreciation reserves and to distribute the relative shares as a bonus among shareholders. The issue of shares in these circumstances could never be a distribution of profit.

Sub-section (b) following the definition of dividend is a pointer perhaps to what the draftsman *intended* but what, in my opinion, he succeeded in doing by drawing no distinction between profit and capital (as in the Australian Act to which I have referred), by making “a distribution of profit” govern the whole conception of what is a dividend, and by including in the Ordinance (section 52) provisions similar to section 21 of the Finance Act, 1922, as amended by the Finance Act, 1927, was to have brought our law into line with the law of England.

I think the Board of Review was right and I would dismiss the appeal with costs.

DE KRETZER J.—I agree.

*Appeal dismissed.*

