

PETITIONER:
COMMISSIONER OF INCOME TAX, KANPUR

Vs.

RESPONDENT:
U.P. STATE INDUSTRIAL DEVELOPMENT CORPORATION

DATE OF JUDGMENT: 11/04/1997

BENCH:
S.C. AGRAWAL, G.T. NANAVATI

ACT:

HEADNOTE:

JUDGMENT:

J U D G M E N T

S.C. AGRAWAL , J.:-

These appeals, by certificate granted under section 261 of the Income Tax Act, 1961 (hereinafter referred to as 'the Act'), have been filed by the Revenue against the judgment of the Allahabad High court dated June 30, 1980 in Income Tax References Nos. 31 and 137 of 1976. By the said judgment the High Court has answered the following question against the Revenue and in favour of the U.P. state Industrial Development corporation (hereinafter referred to as "the assessee"):-

"Whether on the facts and in the circumstances of the case, the Tribunal was justified in holding that under writing commission in the case of shares held by the assessee itself and not actually subscribed by others was reducing the cost of the shares in the hands of the assessee and was not separately taxable as the assessee's income of that year?"

The references relate to the assessment years 1970-71 and 1971-72.

The assessee is a state undertaking. Its shares are wholly subscribed by the state of Uttar Pradesh. It has been incorporated with the object of developing industries in the state of Uttar Pradesh and with that end in view it finances industrial project or enterprises, whether owned firm or individuals etc. one of the clauses for financing the companies by the assessee was that on the share of such companies as well as brokerage on the sale of shares of such companies and in case the shares of such companies were not subscribed by the public in to the assessee was obliged to underwriting commission and brokerage in the same manner as if the shares of such companies were subscribed by the public. The method adopted by the assessee was that instead of crediting the underwriting commission and brokerage to its profits and loss account in the case of such companies the shares of which had to be subscribed by the assessee

itself, it used to reduce the cost of the shares held by it as stock-in-trade. During the previous year relevant to the assessment year 1971-71 the assessee had earned by way of underwriting commission a sum of Rs. 1,01,250/- and brokerage to the extent of Rs.33,719/- while the assessee offered a sum of Rs. 12,535/- out of the aforesaid receipts as its taxable income. In the previous year relevant to the assessment year 1971-72 the assessee earned by way of underwriting commission and brokerage a sum of Rs. 1,15,000/- and no part of it was included in its taxable income. While making the assessment the Income Tax officer added the entire amount received by the assessee by way of underwriting commission and brokerage as part of taxable income for both the assessment years. The Appellate Assistant commissioner, however, held that underwriting commission was assessable as assessee's income in the year in which it accrues, i.e.; in the year in which the underwriting agreement was made. But as regards brokerage he held that brokerage on the shares held by the assessee was not includable in the income of the assessee and that it had to be adjusted against the cost of the shares taken. The assessee filed appeals against the orders of the Appellate Assistant commissioner before the Income Tax Appellate Tribunal (hereinafter referred to as "the Tribunal"). The Revenue did not question the order of the Appellate Assistant commissioner regarding brokerage. The Tribunal held that the underwriting commission in respect of the shares held by the assessee would reduce the cost of the shares and would not be separately assessable as the assessee's income. The Tribunal has observed:-

"And this difference by way of commission and brokerage is charged by the underwriter because it agrees to subscribe for a large amount of the capital of the company. As such whatever amount the underwriter earns as underwriting commission, it does not automatically become its income. It is postponed unless the risk of taking or not taking the shares is over. If the shares are fully subscribed, the institution gets commission, even, the commission earned by the corporation is loss account of the assessee. But, if the assessee subscribes some share out of the underwritten shares, the commission relating to those shares goes towards the cost and, therefore, no income is earned by the underwriter."

After referring to various books on accountancy, namely, Accountancy by William Ribbles, 3rd Edn. page 1144(Chapter XXVI); Booking keeping and Accounts by Ernest Even Spicer and Ernest C. Pagler, 10th Edn., page 650; Dicksee's Auditing, 17th Edn., page 279; and Auditing Theory and practice by R.K. Montogomri, 2nd Edn., pages 215-216, the Tribunal has held that the underwriting account is a part of profit and loss account, which includes not only the income from underwriting commission and brokerage but the same is debited by the expenses and the cost of shares, which the underwriting is called upon to take and as much

underwriting commission could not be taken into consideration leaving aside the other items of this account. Account is taken into consideration, the practice followed by the assessee to first adjust the brokerage and underwriting commission towards the cost of the shares, which are underwritten by it but the commission and brokerage earned on shares not subscribed by it are taken to the profit and loss account, was absolutely correct and was in accordance with accountancy principles and, since there is no contrary provision in the Act, the system followed by the assessee must be respected. At the instance of the Revenue the Tribunal has referred the question abovementioned for the opinion of the High Court.

The references were considered by the High Court along with Income Tax Reference No. 37 to 1976 relating to the assessment years 1966-66, 1966-67, 1967-68, 1969-70 wherein also similar question had been referred for the opinion of the High Court. The High Court agreed with the view of the Tribunal and has held that the commission earned by the assessee as underwriter in respect of the shares offered by the company and purchased by the public, would undoubtedly be the profit and loss account, but so far as the shares agreed by the assessee to be underwritten and purchased by it are concerned, the transaction in substance results in the assessee purchasing those shares for a consideration which is equal to the face value of the shares as reduced by the amount of commission and brokerage and in such a case, the amount of commission and brokerage and in such a case, the amount of underwriting commission and brokerage merely goes to reduce the value of the shares and it cannot be considered to be the income of the assessee. The High Court, however, felt that the question whether the underwriting commission in relation to shares which the assessee itself subscribed as underwriter went to reduce the cost of those shares or whether such underwriting commission could be taxed as an income is a substantial question of law of general importance and, therefore, it granted certificate of fitness for appeal to this Court under section 261 of the Act. Hence these appeals.

In the case of public companies, when shares are offered to the public for subscription, it is usual to make certain of obtaining the necessary capital by having the shares underwritten. The word "underwriting" means that a person agrees to take up shares specified in the underwriting agreement if the public or other persons fail to subscribe for them. The consideration for this contract takes the form of commission for this contract takes the form of payment of commission". Underwriters are thus paid for the risk they expose themselves to in placing of shares before the public. Under section 76 of the companies Act, 1956.

The question that falls for consideration is whether the underwriting commission in respect of shares which could not be subscribed by the public and had to be purchased by the assessee has to be regarded as the income of the assessee or it goes towards reducing the cost of the shares so purchased. In the accounts maintained by the assessee the underwriting commission is first adjusted towards the cost of the shares that are underwritten and thereafter the commission on shares not subscribed by the assessee is taken to the profit and loss account. The Tribunal has found that the said practice followed by the assessee was in consonance with principles of accountancy governing underwriting account. The Tribunal, after referring to authoritative books on Accountancy, has held that the underwriting

commission is a part of profit and loss account which includes not only the income from underwriting commission and brokerage but the same is debited by the expenses and the cost of shares, which the underwriter is called upon to take and as such underwriting commission could not be taken into consideration leaving aside the other items of this account and, therefore, the underwriting commission in respect of the assessee. The High Court has agreed with the said view of the Tribunal.

The main contention urged by the learned counsel appearing for the Revenue in support of the appeals was that the entitlement to reduction is to be governed by the provisions of law and not by the accounting practice adopted by the assessee and in support of his submission the learned counsel has placed reliance on the decision of this Court in Kedar Nath Jute Manufacturing Company v. Commissioner of Income Tax, (1971) 82 ITR 363; Morvi Industries Ltd. v. Commissioner of Income Tax, (1971) 82 ITR 835, and state of Travancore v. Commissioner of Income Tax, (1986) 158 ITR 102.

In our opinion, this contention is devoid of force. The accounting practice followed by the assessee in the instant case was in consonance with general principles of accountancy governing underwriting accounts. It is a well accepted proposition that "for the purposes of ascertaining profit and gains the ordinary principles of commercial accounting should be applied, so long as they do not conflict with any express provision of the relevant statute". [See: Whimster & co. v. commissioners of Inland Revenue, 12 T.C. 813; Commissioner of Inland Revenue v. Cock, Russell & Co. Ltd. 29 T.C. 387]. This proposition has been affirmed by this court in P.M. Mohammed Meerakhan v. commissioner of Income Tax, Kerala, (1969) 73 ITR 735. In the said case it has observed:-

"For that purpose it was the duty of the income Tax officer to find out what profit the business has made according to the true accountancy practice." [P.743]

The decisions on which reliance has been placed by the learned counsel for the Revenue do not depart from this principle.

In Kedar Nath Jute Manufacturing Company v. Commissioner of Income Tax (supra) this court was considering the question whether the amount of sales tax paid or payable by the assessee is an expenditure within the meaning of section 10(2) (xv) of the Income Tax Act, 1922. The said claim of the assessee was disallowed by the Income Tax officer on the ground that the assessee was following the mercantile systems of accounting and had made no provision in its books with regard to payment of that amount. Upholding the claim of the assessee for deduction of the said amount, this court has held that whether the assessee is entitled to a particular deduction or not will depend on the provision of law relating thereto and not on the view which the assessee might take of his rights nor can the existence or absence of entries in the books of account be decisive or conclusive in the matter. In this case the question whether the principles of accounting have to be taken into account for ascertainment of profit did not fall for consideration.

The decision in Morvi Industries Ltd. v. commissioner of Income Tax (supra) also does not deal with this question. In that case this court has explained the meaning of the word "accrued" used in section 4(1) (b) (i) of the Income

Tax Act, 1922 and has observed that income can be said to have accrued when it becomes due and the postponement of the date of payment has bearing only so far as time of payment is concerned but it does not affect the accrual of income.

State of Travancore V. Commissioner of Income Tax (supra) was a case where the assessee-Bank, instead of carrying the interest on sticky advances, i.e., advances which had become extremely doubtful of recovery, to the profit and loss account, had credited it to a separate account called the Interest Suspense Account'. The question was whether the said interest was taxable. Tulzapurkar J., in his dissenting judgment held that the said income was not an income and was taxable and observed that even in mercantile system of accounting it is only the accrual of real income which is chargeable to tax and accrual is a matter of substance to be decided on commercial principles having regard to the business character of the transaction having regard to the business character of the transactions and the realities and specialities of the situation and cannot be determined by adopting a purely theoretical or doctrinaire or doctrinaire or legalist approach. The learned Judge has referred to standard text books on accountancy to show that in case of interest on sticky loans the practice of debiting the accounts of the concerned debtors with interest and carrying the same to Interest suspense Account instead of the interest account or profit and loss account is well recognised and accepted practice of commercial accountancy which is wholly consistent with the mercantile system of accounting. Sabyasachi Mukharji J. (as the learned chief Justice then was), however, held that the interest on sticky advances had accrued according to the mercantile system of accounting because the assessee-Bank had debited the respective parties with the interest, which it could have, as a bad debt, did not offer it for taxation but carried it to the Interest suspense Account and that carrying a certain amount which had accrued as interest without treating it as a bad debt or irrecoverable interest but keeping it in suspense account was repugnant to section 36(1) (iii) read with section 36(2) of the Act. The learned Judge, after taking note of the recognised books on accountancy to which reference had been made by Tulzapurkar J., observed:-

"Even if in a given circumstance, the amounts may be treated as interest suspense account for accountancy purpose, that would not affect the question of taxability as such. This must be determined by well-settled legal principles and principles of accountancy which have been referred to hereinbefore".

Ranganath Mishra J. (as the learned chief Justice then was) concurred with reasonings and conclusions of Mukharji J. The aforementioned observations of Mukharji J. also postulate that for determining the question of taxability well settled legal principles as well as principles of accountancy have to be taken into account. In that case the learned Judge held that without treating the amount which had accrued as interest as a bad debt or irrecoverable interest but keeping it in suspense amount was repugnant to section 36(1)(vii) read with section 36(2) of the Act and, therefore, even if the amount might be taken to the Interest Suspense Account for accounting Purposes, that would not affect its taxability as such.

In the present case, the Tribunal, after referring to authoritative books on Accountancy, has found that the assessee was maintaining the accounts correctly in accordance with the principles of accountancy applicable to underwriting accounts and keeping in view the said principles the underwriting commission on the shares which were not subscribed by the public and were purchased by the assessee could not be treated as profit earned by the assessee in the transaction and the said commission could only be treated as reducing the price of the shares purchased by the assessee. The Tribunal has also stated that there is no contrary provision in the Act. The learned counsel for the Revenue has not shown that the accountancy practice followed by the assessee is repugnant to any provision of the Act. In the circumstances, it must be held that the Tribunal has not committed any error in taking the view that the underwriting commission earned by the assessee in respect of the shares which were not subscribed by the public and were purchased by the assessee could not be treated as a part of its taxable income. The question referred was, therefore, rightly answered by the High Court against the Revenue and in favour of the assessee.

As a result, the appeals fail and are accordingly dismissed. No order as to costs.